Volume 34 | Issue 3 Article 10

1957

Vol. 34, no. 3: Full Issue

Dicta Editorial Board

DICTA

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VOLUME 34

1957

The Denver Bar Association

The Colorado Bar Association

The University of Denver College of Law

1957

dicta

Vol. XXXIV, No. 3 **May-June, 1957**

Published bi-monthly by the Denver Bar Association, the Colorado Bar Association and the University of Denver College of Law.

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SUBSCRIPTIONS AND CONTRIBUTIONS: Mail all contributions and orders for subscriptions or back issues to Dicta Business Manager, University of Denver, College of Law, Denver, Colorado.

ONE YEAR REVIEW OF CORPORATIONS, PARTNERSHIP, AND AGENCY*

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Corporations:

The case of *Miller v. Hepner*[1] is the sequel to *Hepner v. Miller*.[2] The Supreme Court in *Hepner v. Miller* had held "that a court has no power, in the absence of a permissive statute, to dissolve a going solvent corporation; to appoint a receiver to sell its assets, and divide the proceeds of such sale among the stockholders."[3] The court ordered the case remanded, with directions to discharge the receiver and to dismiss the action.

Miller v. Hepner involved the question whether the trial court was correct in fixing: (a) the receiver's fee at $100 a month for the twelve months he acted as such, (b) $750 as the fee for the receiver's attorney, and (c) the fee of appraisers retained by the receiver to appraise the corporate real estate. The second question was whether such expenses should be charged against the plaintiff stockholders who brought the action for the appointment of the receiver. The trial court decided all these issues against the plaintiffs. *Held*, judgment modified by reducing the receiver's fee and his attorney's fee by fifty per cent. The supreme court held with the trial court that such fees were chargeable to plaintiff stockholders, who had improperly obtained the appointment of the receiver. But, "As to the fees for appraisal of the real estate, it is to be observed that this appraisal was premature on the part of the receiver and it is only fair and just that he be directed to pay this item."[4]

In *Fehr v. Hadden*,[5] plaintiffs were stockholders in a mutual nonprofit corporation organized under the Colorado statutes for the purpose of acquiring and distributing water for domestic purposes in Jefferson County. All water users were required to own stock in the corporation. The plaintiffs brought action against the corporation and its directors, to have an election of directors declared invalid on the grounds: (1) that certain record stock owners allowed to vote at the election were building contractors, and should not have been allowed to vote, because they might dispose of their stock to purchasers of homes, and that they, therefore, were not bona fide stockholders for the purpose of voting; and (2) that certain record stockholders were not bona fide equitable owners of stock because they had contracted to sell the stock to others, and consequently should not have been allowed to vote. The trial court entered judgment for the defendant directors. *Held*, judgment affirmed. (a) The Colorado statute[6] provides that, unless the articles of incorporation of a Colorado corporation shall provide to the contrary, every shareholder of record is entitled at every shareholders' meeting to one

* This article concludes the review of cases decided between Nov. 1, 1955 and Jan. 1, 1957. For six other annual review articles see 34 DICTA 69-122 (1957).

[1] 132 Colo. 395, 292 P.2d 968 (1955).

[2] 130 Colo. 243, 274 P.2d 818 (1954); see Note, 32 DICTA 314 (1955).

[3] 130 Colo. at 246, 274 P.2d at 819.

[4] 132 Colo. at 399, 292 P.2d at 970.

[5] 300 P.2d 533 (1956).

[6] Colo. Rev. Stat. Ann. § 31-2-7 (1953).

vote for every share standing in his name on the books of the corporation. There was nothing to indicate that the articles of incorporation provided for any limitation on voting rights. Consequently, the building contractors' intention to sell their stock at some time in the future did not disqualify the stock from being voted. (b) The Colorado stock transfer act expressly permits a corporation to "recognize the exclusive right of a person registered on its books as the owner of shares . . . to vote as such owner. . . ."[7] And the same act contains the definition: "(i) 'Title' means legal title and does not include a merely equitable or beneficial ownership or interest."[8] Therefore, the mere fact that certain stockholders of record had contracted to sell their stock would not preclude them from voting that stock.

The case of *Colorado Builders' Supply Co. v. Hinman Brothers Construction Co.*[9] involved the question of what constitutes doing business within the state by a foreign corporation so as to make it amenable to process served on its employees within the state. The defendant corporation, an Illinois corporation, had not qualified to do business in Colorado, nor had it designated an agent for process. It manufactured heavy earth-moving machinery in its plants in Illinois and Georgia, and sold its products in Colorado, and portions of Nebraska and Wyoming, through an exclusive distributor, the plaintiff, a corporation.

[7] *Id.* § 31-9-3.
[8] *Id.* § 31-9-21.
[9] 304 P.2d 892 (1956).

The plaintiff was the defendant's distributor for just less than a month, from May 1, 1953, to May 29, 1953, and from the latter date to October 12, 1953, the defendant had no distributor in Colorado. In September 1953, one Murphy became the defendant's district representative. Murphy's first efforts were toward finding a suitable distributor for his company, and on October 12, 1953, Liberty Company became the distributor in Colorado. Murphy made his services available to Liberty in providing the personnel with a working knowledge of the equipment and in giving sales training to Liberty employees. On some occasions, he accompanied Liberty salesmen in meeting prospective customers. At all times following his appointment, Murphy spent a very substantial portion of his time outside Colorado, although he lived in Denver because of its central location. He made written reports of his work to the defendant corporation. He was paid a fixed salary by the defendant, drew no commissions, and was not supplied with an office.

In addition to the district representative, the defendant corporation employed one Slade as a service engineer. The area to which he was assigned comprised all the United States west of and including Texas, Oklahoma, Kansas, Iowa, Minnesota, Wisconsin, as well as portions of Canada, Alaska, and Hawaii. His duties were to train and counsel distributors on problems of maintenance, repair, and upkeep of machines made by defendant. He worked under direct orders from the factory, and was in no way responsible to the distributor. When Liberty became a distributor in Colorado, its employees were not familiar with the equipment and had to be trained to service and maintain it. Slade occasionally went with the distributor's service man on a repair job, because the distributor's employee was too inexperienced to locate the trouble with the equipment. Slade was paid a salary by the defendant, and the defendant was not reimbursed by the distributor in the few instances in which Liberty called upon Slade to assist in repair work.

The plaintiff served process, in an action in personam against defendant corporation, on both Murphy and Slade, referring to each, in the return of service, as "agent and principal employee" of the defendant. The defendant moved to quash the service of process on the grounds: (1) that it was not engaged in business in Colorado; and (2) that the persons served were not agents for accepting service of process. After hearing evidence, the trial court determined that the defendant corporation was not "doing business" within Colorado so as to be amenable to process served within the state. *Held,* judgment affirmed.

In *Western Homes, Inc. v. District Court,*[10] it was held: "A corporation can conspire and can commit a tort."[11] The alleged tort was common law deceit.

Partnership:

The only partnership case found is *Bennett v. Gardner.*[12] In that case the plaintiff brought an action against his former partner for an accounting. He alleged a loan of $800 to the former partner and, on information and belief, alleged that $5,000 was the approximate amount due for assets sold and unaccounted for by the former partner. The trial court was unsatisfied with the account filed by the defendant on court order, because the court considered it incomplete. The defendant's counsel claimed that the defendant could not submit any other records. Thereupon, on motion of the plaintiff, the court entered judgment for the plaintiff for $5,800 as prayed for in the complaint, "since any other course of action appeared useless."[13] *Held,* reversed and remanded to the trial court, with direction to vacate the judgment against defendant and grant a new trial. It was encumbent on the plaintiff to establish his case by evidence of the amount due under the accounting, "and the court cannot, without proof, assume that the amount due plaintiff is the sum named in his complaint."[14]

In the supreme court's report of the *Bennett* case, it is difficult to discover whether the court considered that either a real partnership or a real joint adventure had been formed. It speaks of "the so-called partnership agreement." Assuming that partnership law was involved, the case poses a real problem for the dormant partner who asks for a court accounting, on dissolution, from the active partner who was in entire charge of the business. When the active partner refuses to file a complete account as ordered by the trial court, is the court powerless to give relief to the dormant partner? Maybe the trial court could cite the active partner for contempt of court, but that would not benefit the dormant partner in a pecuniary way. Strangely, not a single case is cited by the Supreme Court for its holding, nor did it cite the Uniform Partnership Act,[15] adopted in Colorado.

Agency:

Cases concerning the relationship of principal and agent, and master and servant, are included here, but workmen's compensation cases are omitted.

Three cases deal with real estate brokers. The first is *McCullough v. Thompson.*[16] In that case, the defendants, the owners of certain real property, listed the property with the plaintiffs, real estate

[10] 133 Colo. 304, 296 P.2d 460 (1956).
[11] *Id.* at 310, 296 P.2d at 463.
[12] 133 Colo. 33, 291 P.2d 705 (1955).
[13] *Id.* at 37, 291 P.2d at 707.
[14] *Id.* at 38, 291 P.2d at 708.
[15] Colo. Rev. Stat. Ann. §§ 104-1-1 to 43 (1953).
[16] 133 Colo. 352, 295 P.2d 221 (1956).

agents, for sale at a certain price. The defendants agreed in writing to pay the agents a commission of five per cent if a purchaser ready, willing, and able to buy the property on the terms prescribed was found within sixty days. The agents did find such a purchaser within sixty days, but the defendants refused to go through with the sale. Thereupon, the plaintiffs sued for the agreed commission, with interest, and obtained a judgment for that amount. *Held*, judgment affirmed. "Under the pertinent statute . . . they were entitled to their commission."[17]

In *Ginsberg v. Frankenberg*,[18] the defendant gave a non-exclusive listing of his property to the plaintiff, a real estate broker who was also an attorney. The contract of listing was drafted by the plaintiff, and provided for a commission to the plaintiff if he found a purchaser willing to pay the amount asked by the defendant. Plaintiff was unable to find such a purchaser. Defendant subsequently sold the property through another agent, and paid the latter a commission. Plaintiff sued the defendant, claiming he had earned a commission. In the trial court, after the plaintiff had put in his evidence, the defendant moved for a nonsuit and dismissal of the complaint. This motion was granted. *Held*, judgment affirmed. The supreme court stated that if there was any ambiguity in the contract, it must be construed against the writer. The court then went on to say: "Recovery in this case is not only barred by the decisions of this court, but by . . . ." the statute.[19]

In *Heady v. Tomlinson*,[20] a real estate broker brought action to recover a commission for effecting a sale of real estate for the defendant. The defendant had been negotiating with one Larreau regarding selling to Larreau certain wheat land owned by the defendant. Later, Larreau introduced the plaintiff to defendant; and upon the plaintiff's representation to the defendant that he would have some cash buyers on the defendant's land the next day, the defendant agreed to allow the plaintiff to show the land for sale and to pay a commission to the plaintiff if a sale was made. Larreau later decided to buy the land and he informed the plaintiff of his desire. The plaintiff showed the defendant's land to certain prospective cash buyers, but a sale did not materialize. The plaintiff

[17] *Id.* at 355, 295 P.2d at 222 [citing Colo. Rev. Stat. Ann. § 117-2-1 (1953)].
[18] 133 Colo. 382, 295 P.2d 1036 (1956).
[19] Colo. Rev. Stat. Ann. § 117-2-1 (1953).
[20] 299 P.2d 120 (1956).

then informed the defendant of Larreau's offer, and the defendant informed the plaintiff that he would accept Larreau's offer. Subsequently a contract of sale was entered into between the defendant and Larreau, at which time the plaintiff was present. Plaintiff demanded his commission from the defendant, but the defendant refused to pay it, on the basis that he, and not the plaintiff, had produced the buyer. The case was tried to the court without a jury, and judgment was entered for the plaintiff. *Held,* judgment reversed and the cause remanded with directions to enter judgment for the defendant. The plaintiff did not produce a purchaser. Defendant and the purchaser had already been negotiating for the sale of the property, and plaintiff did nothing to induce the buyer to purchase the property.

In *Weick v. Rickenbaugh Cadillac Co.,*[21] suit was brought by the administrator of the estate of decedent to recover commissions which plaintiff claimed that his decedent had earned while employed as sales manager for the defendant automobile distributing company. The contract between the plaintiff's intestate and the company was silent as to when the plaintiff's commission would be deemed earned. Under the contract, the plaintiff's intestate was to receive a certain per cent of the sale price of all cars sold by the defendant company, as his commission as sales manager. Plaintiff contended that the contract included cars sold during his intestate's lifetime but delivered afterwards. The practice of the defendant company was to pay the commissions on the fifteenth day of the month following the last month of each quarter. The trial court held that the plaintiff's intestate was not entitled to commissions on cars sold prior to his death but delivered afterwards. *Held,* reversed. "The basic error lies in the failure of the trial court to recognize the distinction between the time when a commission is earned and the time when it may become due and payable.[22]

Garden of the Gods Village v. Hellman[23] involved the distinction between the relationship of principal-agent and the relationship of employer-independent contractor. Defendant corporation was engaged in developing its real property for the purpose of subdividing the land into lots to be sold to the public. Heyn was president of the corporation and controlled practically all of its issued stock. The corporation, through Heyn, employed two brothers at a stipulated wage per hour to blast out some large rocks that were on the land. One of the brothers suggested to Heyn that about a hundred holes should be bored and then fired with light loads of blasting material. However, to save cost, Heyn directed that only four or five holes be bored and then fired with heavy loads. As a result of the brothers' following Heyn's directions, plaintiff's nearby building was materially damaged by concussion from the blasting. The plaintiff obtained a verdict and judgment against the defendant corporation. *Held,* judgment affirmed. The court first found that the brothers were not independent contractors but were servants of the corporation, and "it was liable for any damage result-

[21] 303 P.2d 685 (1956).
[22] *Id.* at 687.
[23] 133 Colo. 286, 294 P.2d 597 (1956).

ing from their operations. . . ."[24] The court then observed that the work was of an inherently dangerous character, and in such a case an employer cannot evade liability by engaging an independent contractor.

The case of *Radosevich v. Pegues*[25] involved the question whether an attorney, who has entered his appearance on behalf of a party to an action, may compromise and settle his client's claim without the knowledge and consent of his client. The facts are somewhat involved, but it will suffice for our purposes to say that the supreme court followed settled Colorado authority in stating that the attorney "may not compromise his client's cause without express authority."[26]

Two master and servant cases were decided by the Colorado Supreme Court. (Workmen's compensation cases are omitted here.) One of the master-servant cases, interesting on its facts, is *Lombardy v. Stees.*[27] Defendant was the owner of the Pioneer Hotel and bar in Steamboat Springs, and one Brasier was in his employ as bartender. Brasier was instructed not to serve any patron who had had too much to drink. The plaintiff entered the bar one night, drank several glasses of beer, and then argued with the bartender over whether the latter had given him the proper change. The plaintiff claimed that, later, the bartender asked him to leave, and when he was a few feet from the door the bartender came from behind the bar and beat him with a golf club handle. The bartender claimed that the plaintiff called him a "dirty name" and that he thought the plaintiff was looking for trouble with him personally and not with the patrons of the bar. The plaintiff sued the defendant and the bartender for his injuries. The first trial was before a jury, which failed to reach a verdict. Another trial was had with no service being had on the bartender and no appearance being made for him. The court instructed the jury as to acts of the servant entirely for his own purposes being beyond the scope of his employment, and added:

> "The fact, however, if it be a fact, that at the time of and in the perpetration of the wrongful act complained of, the servant was combining some private purpose of his own with the business of his master is not of itself sufficient to take the wrongful act outside of the scope of the authority and employment, and the master will not on that account be relieved from liability."[28]

Counsel for the defendant objected to the instruction, but was overruled. The jury brought in a verdict for the plaintiff for $20,000, and judgment was entered thereon. *Held,* judgment reversed and the cause remanded with directions to dismiss the complaint. The supreme court stated that the above-quoted instruction was erroneous, because there was no evidence in the case to show that the bartender was acting partly in behalf of his master.

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[24] *Id.* at 294, 294 P.2d at 601.
[25] 133 Colo. 148, 292 P.2d 741 (1956).
[26] *Id.* at 152, 292 P.2d at 743 (dictum).
[27] 132 Colo. 570, 290 P.2d 1110 (1955).
[28] *Id.* at 575, 290 P.2d at 1112.

It seems to us that the supreme court was somewhat naive in its examination of some of the evidence. For instance, the court said: "There was a stick, apparently the handle of a golf club, in the bar and it is not shown by the evidence that it was used for any purpose in the operation of the bar as such."[29] Would it not be more realistic to say that the stick was kept there, behind the bar, for some useful purpose connected with the operation of the bar? It certainly was not kept there for playing golf, since it was useless as a golf club.

Whether the bartender was acting within the scope of his employment was properly a jury question, and since the evidence on that point was conflicting, the direction given by the trial court was proper. The local jury was in a much better position to determine who was telling the truth than was the appellate court, which read the abstract of record and the briefs in Denver.

A case equally interesting on its facts as the preceding one, but not as doubtfully decided is *Bidlake v. Shirley Hotel.*[30] There the plaintiff drove his car up to the entrance of the Shirley-Savoy Hotel, operated by the defendant in Denver, preparatory to registering as a guest. He was asked by the defendant's uniformed employee if he desired his car stored. Plaintiff answered in the affirmative and gave the car keys to the employee, a night porter. Instead of taking the car to the garage, the employee used it for a "joy-ride" and damaged it. Upon the plaintiff's recovering the car the next day, valuable personal property had been taken from the glove compartment. Plaintiff sued the defendant hotel for the damage to the car and the loss of the personal property. Defendant set up in defense that the employee had no authority to take the plaintiff's automobile to a garage and that the employee converted the automobile to his own use. The defendant gave evidence tending to show: that it was not the practice of employees of the hotel to take guests' cars to the nearby garage for storage; that the doorman ordinarily was the person who would take the car keys of a guest who wished his car stored; that the doorman would give the guest a claim-check and would call the garage to have it send a shag-boy to come for the car; that the employees had been instructed that only the supervisor and the doorman should ever drive move a guest's car and then only in an emergency; and that it was not the custom in Denver to permit porters or bellhops to drive automobiles of guests arriving by automobile. The trial was to the court, and at the conclusion of all the evidence judgment was entered in favor of the defendant. *Held,* judgment reversed. A guest registering at a hotel has no duty to inquire as to the limitations of an employee's authority. Defendant had vested the uniformed employee with apparent authority to accept on its behalf the delivery of the plaintiff's automobile for storage.

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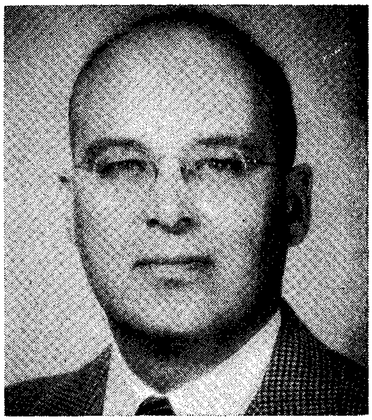
[29] *Id.* at 572, 290 P.2d at 1111.
[30] 133 Colo. 166, 292 P.2d 749 (1956).

FEDERAL INCOME TAX ASPECTS OF DAMAGES

By Everett E. Smith



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A recent, responsible review of the law of damages begins with this sentence "Probably no branch of the law is more confused, less considered, or more often applied than damages."[1] A United States Supreme Court Justice who once had been Chief Counsel for the Internal Revenue Service described the tax law as "a field beset with invisible boomerangs"[2] and, on another occasion, as "so complex as to be the despair of judges."[3]

It is the boundary of these two distinctive fields of law which we propose to survey.[4] It ought to be an area of special interest to the general practitioner.[5] To him who is already in the case the litigant ordinarily will turn for advice and assistance concerning the tax consequences of a contemplated suit, a proposal of settlement or a favorable or unfavorable judgment. As for the tax specialist, his competence in his specialty depends on his knowledge of its points of contact with the various other branches of law, such as damages. A tax lawyer ignorant of general legal problems and principles is as handicapped as a general practitioner who does not recognize a tax problem when he sees it.

It is not the objective of this article, of course, to make a tax expert of anyone, even in the area under review and least of all to minimize the general practitioner's need for the cooperation of the tax specialist in specific instances and at crucial steps. Equally far from our aim is offering an exhaustive analysis and collection of authorities which will furnish a ready-made answer to any specific problem now puzzling a tax expert. Rather, it is our modest purpose to give recent illustrations of some actual tax problems which have arisen from litigation and caused enough difficulty to find a place in the reports; to place them in perspective; and to provide

[1] Developments in the Law—Damages, 61 Harv. L. Rev. 113 (1947).
[2] See Arrowsmith v. Commissioner, 344 U. S. 6, 12 (1952).
[3] See Dobson v. Commissioner, 320 U. S. 489, 498 (1944).
[4] For a trail-blazing article which covers the same territory, and more, see Plumb, Income Tax on Gains and Losses in Litigation, 25 Cornell L. Q. 221, 26 Cornell L. Q. 16 (1940). See also Mertens, Federal Income Taxation § 5.21 (1942); Note, Taxation of Damage Recoveries from Litigation, 40 Cornell L. Q. 345 (1955).
[5] "No other branch of the law touches human activities at so many points." Mr. Justice Jackson speaking for the Court in Dobson v. Commissioner, 320 U. S. 489, 494-5 (1944).

a readily available reference to the decisions and rulings which have dealt with those matters. Accordingly, the law as applied in given cases takes priority in the discussion over our own ideas of what it should be in the same cases, in unreported settlements, or in hypothetical situations. Finally, we usually have placed the emphasis on the principles which determine the answers rather than on the answers themselves.

As used herein, damages includes judgments and settlements interchangeably.[6] Those judgments and settlements relating to divorce and to the annulment of marriages, though forming a part of the general subject now under consideration, are governed by special rules and for that reason are excluded from the scope of the present discourse. The question *when* a reportable or deductible judgment for damages should be taken into account (involving such doctrines as accrual and constructive receipt) is likewise beyond the pale of our attention. For present purposes, but present purposes only, we indulge the pleasant assumption that all judgments are collectible by the creditor and payable by the debtor without great difficulty or delay.

In general, gains and losses suffered in litigation are not in a class by themselves. They are merely special instances of the actual or intended application of principles of federal income tax law which embrace other classes of gains and losses. It follows from this fact that the tax treatment of damages and settlements seldom, if

[6] Cf. Lyeth v. Hoey, 305 U. S. 188, 196 (1938), "We think that the distinction sought to be made between acquisition through such a judgment and acquisition by a compromise agreement in lieu of such a judgment is too formal to be sound . . . ."

ever, depends on such common-law characterizations as torts, contracts and trusts. The important categories are those of the revenue law, and this means that the text of the applicable code should be kept in mind.

The code, it must be conceded, rarely contains a complete and final statement of the governing law, for here, even more than in the case of other statutes, the gloss of administrative rulings and court decisions is important. So true is this that it is difficult to say whether the code should be considered a starting point rather than a point of departure. Notwithstanding these reservations, the text of the code is at least a point of reference or orientation which should be kept in view, like a lighthouse, by all the legal mariners who seek the harbor of minimized taxes.

To conclude these introductory remarks, a litigant who has obtained a favorable, final judgment, or received money or other property in settlement of a suit, sometimes faces an adversary more formidable than the just vanquished, for the federal tax collector may insist on sharing with him the fruits of victory. As for the losing litigant, there are times when his loss, after taxes, may be substantially less than the full amount which must be or has been paid in satisfaction of a judgment or in settlement of a suit. The tax opportunities of the losing litigant will be considered later, in Part II.

PART I—FAVORABLE JUDGMENTS

As will be shown in more detail as we go along, a successful litigant may urge that his recovery: (a) is not comprehended within the broad concept of taxable income; (b) irrespective of possible inclusion within the statutory purview of gross income, the judgment is excluded from taxation by certain provisions of the code; or (c) the recovery is entitled to one of the various types of relatively preferential treatment specified in the present or the prior code, which ever is applicable under the circumstances.

Section 61 of the Internal Revenue Code of 1954, which is coextensive with corresponding provisions of prior statutes, sweeps "all income from whatever source derived" within the taxable ambit of gross income. There are statutory illustrations of various kinds of taxable income, but no statutory definition which may be used as a criterion or test for determining whether an apparent increase of wealth is real, is recognizable and is income. The opin-

[7] See Commissioner v. Glenshaw Glass Co., 348 U. S. 426, 431 (1955).

ions of courts are similarly devoid of any authoritative definition which may be used as "a touchstone to all future gross income questions."[7]

As indicated above, there are certain specific statutory exclusions from gross income. For example, section 102(a) of the present code provides, as did the corresponding section of the prior code, that "Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance." Section 104(a) contains the following additional provisions which are pertinent here:

> (a) In General.—Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—
>
> (1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;
>
> (2) the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness . . . .

Bequest or inheritance. In the leading case of *Lyeth v. Hoey,*[8] the Supreme Court of the United States ruled that a sum which a son of a deceased daughter of a decedent received in compromise of litigation attacking the validity of a will of the latter was protected from the grasp of the collector by the provision excluding the taxation of the value of property acquired by inheritance. The will had been drawn so as to benefit a charity at the expense of the taxpayer. The Court pointed out that the taxpayer's heirship underlay the compromise agreement. In a much more recent case, the Tax Court denied the protection of the statutory provision to a taxpayer who was unrelated to the decedent but who had received money in settlement of litigation based on the decedent's alleged contract to provide for the taxpayer, an employee, by will.[9]

Workmen's compensation. In *William L. Neill*[10] the taxpayer had not received what ordinarily would be considered a workmen's compensation award or judgment. The Tax Court, though doubting that the provisions relating to workmen's compensation "are literally applicable," gave the benefit of provisions comparable to those above quoted from section 104 to a policeman retired for disability incurred in line of duty. An earlier decision by the Court of Appeals for the District of Columbia[11] insisted on a more literal

[8] 305 U. S. 188 (1938).
[9] John Davies, 23 T. C. 524 (1954).
[10] 17 T. C. 1015 (1951).
[11] Waller v. United States, 180 F.2d 194 (D. C. Cir. 1950).

application of the statutory language in question and a quite recent pronouncement of the Tax Court[12] seems to look more favorably on the restrictive decision of the Court of Appeals than on the Tax Court's own more liberal holding in the Neill case.

Personal injuries. The precise scope of the exclusion of recoveries received "on account of personal injuries" has not been spelled out in litigation or otherwise to the extent that might be expected. This may be the result of two factors: (a) In the past, perhaps more than will be true in the future, reliance has been placed on the limitations of, or implied exclusions from, the statutory income concept; and (b) revenue officials may have been reluctant to test out every conceivable legal possibility of revenue at the expense of an injured class whose net recoveries seldom are considered by its members as full compensatory however impressive gross recoveries may seem to others.

In *Joseph Frank*[13] the Tax Court found that the taxpayer had failed to establish that part of his recovery was based on an assault and on that ground the court denied him the benefit of the express statutory exclusion for personal injuries. An early decision by the Board of Tax Appeals, now the Tax Court, held that damages for libelling the taxpayer personally (not in his professional capacity) were not within the statutory income concept.[14] A recent administrative ruling placed the non-taxability of recoveries for wrongful death on the same basis.[15] It would seem that the latter ruling at least could have been rested on the provisions of the express exclusion of damages received on account of personal injuries. There is authoritative precedent from the field of general law for applying the evident policy and not merely the literal and express terms of a statute.[16] As we learn still elsewhere, "the letter killeth, but the spirit giveth life."

The interest *on* a personal injury judgment appears includible in gross income on the basis of an early decision.[17] Damages related to impaired earning capacity, past as well as future, *may* be entitled to the benift of the exclusion of items received "on account of personal injuries." Despite what is said in a moment about the absence of any implied exclusion of punitive damages, exemplary damages awarded in a personal injury case may be held within the exclusion from gross income expressed in section 104(a)(2) and its predecessors.

Punitive damages. In March 1955 the Supreme Court of the United States handed down a decision in the case of *Commissioner v. Glenshaw Glass Co.*[18] In that case the Supreme Court held that treble or punitive damages awarded in federal antitrust litigation were within the concept of income subjected to tax by section 22(a), the equivalent of the present section 61. In effect, the Court

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[12] Charles F. Brown, 25 T. C. 220 (1955).

[13] 22 T. C. 945 (1954), *aff'd per curiam*, 226 F.2d 600 (6th Cir. 1955). Whether income taxes should be taken into account in fixing damages for personal injuries is, of course, a quite different question. Cf. Stokes v. United States, 144 F.2d 82 (2nd Cir. 1944) (no error in refusing to make a deduction for income taxes).

[14] C. A. Hawkins, 6 B. T. A. 1023 (1927).

[15] Rev. Rul. 54-19, 1954-1 Cum. Bull. 179.

[16] E. g., Keifer & Keifer v. RFC, 306 U. S. 381 (1939).

[17] Theodate Pope Riddle, 27 B. T. A. 1339 (1933).

[18] 348 U. S. 426. (1955).

held that the punitive damages constituted gross income and were not the beneficiaries of any implied exclusion from gross income. The Court pointed out that the Commissioner of Internal Revenue had published his non-acquiescence in a contrary decision which the Board of Tax Appeals had made in 1940 and consistently thereafter had asserted the taxability of such receipts.

Insider profits. On the same day that the Supreme Court decided the *Glenshaw Glass* case, the Court also ruled taxable the "insider profits" recovered by a corporation from a director who had dealt in the securities of the corporation.[19] With respect to such profits the Court said, "There is no indication that Congress intended to exempt them from coverage."[20]

Whether income or recovery of capital. It is the clear import of the two Supreme Court decisions just mentioned that all "gains" are includible in gross income unless specifically excluded. This still leaves open and at large the basic, bedrock question whether a given recovery is a "gain" or "income" or, on the contrary, is a recovery of capital. The answer to that question, as will be seen, may depend in considerable measure on what relief counsel has asked for in his pleading, the language of the agreement in compromise, and the proof presented on the respective trials. It may not be surprising, in view of the above-mentioned confusion in which the law of damages is enveloped, that the decision of this tax issue seldom has been made to turn on the nature of damages as a matter of stautuory or common law. In a recent case, however, in which a portion of a recovery in a partnership accounting was held capital, this factor was recognized as a favorable one to the taxpayer under the circumstances.[21]

(a) Recovery of capital. In *Durkee v. Commissioner*[22] the appellate court was asked to decide the taxability of a sum which the taxpayer, an electrical contractor, received in settlement of a tort action which charged the defendants with combining to injure the taxpayer's business. The court indicated its opinion that a portion of the settlement represented a recovery of a capital item, goodwill, and it remanded the case to the Tax Court for a

[19] General American Investors Co. v. Commissioners, 348 U. S. 434 (1955). See also Commissioners v. Lo Bue, 351 U. S. 243 (1956) (holding certain options to purchase stock to be income).
[20] General American Investors Co. v. Commissioner, 434.
[21] Specialty Engineering Co., 12 T. C. 1173 (1949). See Uniform Partnership Act § 42.
[22] 162 F.2d 184 (6th Cir. 1947). See also Farmers & Merchants Bank v. Commissioner, 59 F.2d 912 (6th Cir. 1932).

determination, among other things, of the unrecovered basis of the asset in question. The court was impressed by the fact that the taxpayer had made no claim for lost profits as such and had merely measured the damage to his goodwill by loss of income.[23]

In *Commissioner v. Pennroad Corp.*[24] the taxpayer's recovery of a large sum on trust principles, as a result of a stockholders' derivative suit, was held to represent capital instead of income. The suit which was settled had alleged a breach of trust in that investments of the taxpayer had been made for the benefit of another corporation rather than for the advantage of the taxpayer. Both the Tax Court and the appellate court agreed that the sums recovered stood in place of losses or impairments of capital which had been caused by the improper investment.[25]

(b) Recovery held income. In a recent case the Tax Court overruled the taxpayer's contention that sums received in settlement of an antitrust suit represented capital in part.[26] The complaint in the suit appeared to demand damages for lost profits rather than damages for injury to business in general and goodwill in particular. In *Mathey v. Commissioner*[27] the appellate court

[23] As for a tort resulting in the physical destruction of specific assets and another tort involving the impairment of property value, see and compare the two cases cited in footnotes 33 and 34 *infra*. Further, note the textual discussion to which the two footnotes pertain.
[24] 228 F.2d 329 (3d Cir. 1955).
[25] See also Ollie Beverly Rose, 8 T. C. 854 (1947).
[26] Chalmers Cullins, 24 T. C. 322 (1955).
[27] 177 F.2d 259 (1st Cir. 1949), *cert. denied*, 339 U. S. 943 (1950). See Avery Corp. v. Fugate, 129 Colo. 595, 272 P.2d 652 (1954) [state income case discussing a judgment rendered in Hyman & Co. v. Velsicol Corp., 123 Colo. 563, 233 P.2d 977 (1951)].

held taxable a damage recovery in a patent infringement suit. In doing so the court stated the rule applicable as follows:

> If it was brought to recover lost profits, the proceeds are taxable as income; if it was brought to recover for loss or damage to capital, the proceeds are non-taxable.[28]

In the early, leading case of *Burnet v. Sanford & Brooks Co.*,[29] the Supreme Court held includible in gross income a taxpayer's recovery on a dredging contract for breach of warranty of the materials to be dredged. It was held that the damages did not constitute capital even though, in a sense, they did no more than restore to the taxpayer a portion of the expenditures made in earlier years in partial performance of the unprofitable contract. The taxpayer was reporting income on a yearly rather than on a completed contract basis.

(c) Burden of proof. In a number of cases taxpayers have been denied the desired treatment of an item as capital in whole or in part because of a failure to establish to the satisfaction of the court that all or a definite part or proportion of a sum received as damages or in settlement was allocable to capital items, such as goodwill, rather than to profits. Possibly no other factor has been cited as often by the courts in recent years as a basis for treating the disputed item as income.[30] At least as early as the launching of the action for tort, breach of contract, breach of trust or whatever, the taxpayer should consider the ways and means of obtaining the maximum recovery after taxes. At the beginning of the litigation is the time to lay the groundwork which will enable proper proof to be made in any later tax dispute. Moreover, the basis of the assets alleged to have been damaged should be considered at the outset and later stages of the litigation.

Whether ordinary income or capital gain. By a statutory definition of general application a capital gain is one which arises from the sale or exchange of a capital asset.[31] Sometimes the facts are such that an "involuntary conversion" may be relied on in lieu of fulfilling the statutory prerequisite by the more common means

[28] But see note 1 *supra* at 181. Cf. Kane, Patent Law, 1954 Ann. Survey Am. L. 420, 422.

[29] 282 U. S. 359 (1931). See Sanders v. Commissioner, 225 F.2d 629 (10th Cir. 1955), *cert. denied*, 350 U. S. 967 (1956) (concerning tax character of money received in settlement of claims under construction contract).

[30] Cf. Phoenix Coal Co. v. Commissioner, 231 F.2d 420 (2d Cir. 1956) (failure of proof—complaint not controlling); Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (1st Cir.) (basis not shown), *cert. denied*, 323 U. S. 779 (1944); H. Liebes & Co. v. Commissioner, 90 F.2d 932 (9th Cir. 1937); Chalmers Cullins, 24 T. C. 322 (1955).

[31] Int. Rev. Code of 1954, § 1222.

of a sale or exchange.[32] Thus in *Walter A. Henshaw*[33] a judgment attibutable to the negligent destruction of oil and gas in place was held to involve an "involuntary conversion" of the asset. Since the taxpayer had no unrecovered basis in the destroyed assets, he was taxable on the entire judgment but, under the circumstances, at the favorable rate applicable to a long-term capital gain. Damages awarded for slander of title appear to stand on a different footing.[34] They represent capital recoveries, but in the ordinary case at least would not be deemed to include gains, capital or otherwise.[35]

The case of *Sarah A. Young*[36] involved a special type of sale or exchange, that of stock surrendered to a corporation in return for corporate assets distributed in liquidation. Actually, the taxpayer had recovered a judgment in a stockholder's derivative suit. but, as the corporation had been liquidated, the judgment inured to the benefit of the taxpayer. The Tax Court held the judgment should be treated as so much received on liquidation of the corporation and be taxed accordingly. There being no unrecovered basis in the stock, the taxpayer in this case was taxable on the entirety of the judgment but as a capital gain, not ordinary income.

In several instances it has been held that a settlement of a seller's suit to rescind a sale of stock is tantamount to a sale of stock for tax purposes and that the sum received is subject to treatment as part of the purchase price.[37] A purchaser who sued for specific performance of the contract to sell but received cash in settlement of the suit was held to have made a sale or exchange of rights in a capital asset with the result that, like the sellers just mentioned, he was able to shield his receipt from treatment as ordinary income.[38] It is noteworthy, however, that in the latter case the taxpayer's right to purchase did not arise from an employment contract and did not constitute partial compensation for services performed.[39] In a case of the kind just mentioned, as in the case of a judgment on a note given for services, the receipt would be ordinary income.[40]

Whether judgment may be attributed to several years. In several recent cases taxpayers have sought to obtain for their settlements or judgments the benefit of the provisions permitting the attribution of income to several years. In one case the Tax Court turned down a claim that a sum received in settlement of a suit for breach of an employment contract deserved treatment as "back pay" under a predecessor of section 1303.[41] In another case the same court held the income item did not relate to services

[32] *Id.* § 1231.
[33] 23 T. C. 176 (1954).
[34] Highlands Farms Corp., 42 B. T. A. 1314 (1940).
[35] See note 23 *supra* together with the pertinent text regarding recovery of capital, and see note 44 *infra* with the related text concerning the usual necessity of a sale or exchange as a prerequisite to capital gain treatment.
[36] 16 T. C. 1424 (1951).
[37] Albert J. Goldsmith, 22 T. C. 1137 (1954) (overruled Government argument that "severance pay" was involved); Margery K. Megargel, 3 T. C. 238 (1944). *But see* Frank T. Feagans, 23 T. C. 208 (1954) (no sale of capital asset, but, rather, a collection of compensation).
[38] Quincy A. Shaw McKean, 6 T. C. 757 (1946).
[39] Cf. Albert C. Becken, Jr., 5 T. C. 498 (1945).
[40] Matilda S. Puelicher, 6 T. C. 300 (1946).
[41] Estate of Lester O. Stearns, 14 T. C. 420 (1950), *aff'd per curiam*, 189 F.2d 259 (6th Cir. 1951).

performed, as required by the provisions invoked, presenting section 1301.[42]

Realization of gain deferred — condemnation — reorganization. The present code, like the one which preceded it, contains provisions spicificallly directed to condemnation and threats or imminence of it. The purpose of the provisions is to permit any gain resulting from the seizure or sale of property in such circumstances to be deferred, or, perhaps, depending on later events, avoided altogether.[43] In a different type of case a taxpayer succeeded in having a gain on the surrender of judgment claims held a "non-taxable transfer" (i.e., the realization of gain deferred).[44] He had surrendered the claims to the debtor in consideration of the issuance to him of stock of the debtor, a transaction which gave the taxpayer and other judgment creditors control of the corporate debtor within the meaning of section 112(b)(5), a section of the old law relating to non-taxable reorganizations.

Judgment collected by assignee — deferred collection — "tax-benefit" rule. A purchaser of a judgment who collects upon it is not deemed to have made a sale or exchange of the judgment.[45] Any gains on such transactions, therefore, are taxable as ordinary income. In the well-known *Dobson* case,[46] the Supreme Court held that the Board of Tax Appeals had committed no error of law in

[42] Curtis B. Dall, 23 T. C. 580 (1954), *aff'd per curiam*, 228 F.2d 526 (2d Cir. 1955).
[43] Int. Rev. Code of 1954, § 1033. For examples of the application of the "involunatry conversion" section of the prior law, see Gaynor News Co., 22 T. C. 1172 (1954); Leon Strauss, 22 T. C. 140 (1954); Rev. Rul. 55-170, 1955-1 Cum Bull. 342.
[44] Alexander E. Duncan, 9 T. C. 468 (1947). *Compare* Int. Rev. Code of 1954, § 351, *with* Int. Rev. Code of 1939, § 112 (b) (5).
[45] Galvin Hudson, 20 T. C. 734 (1953), *aff'd per curiam sub nom.* Ogilvie v. Commissioner, 216 F.2d 748 (6th Cir. 1954).
[46] Dobson v. Commissioner, 320 U. S. 489 (1943).

applying the "tax benefit" rule—a rule which is now embodied in section 111 of the code.

According to the decisions of the Board of Tax Appeals in the *Dobson* and other cases a judgment or cash settlement obtained by a purchaser of stock on the basis of fraud perpetrated by the seller of the stock is required to treat the receipt as ordinary income if in a prior, closed year the stock was sold, a loss taken and a tax benefit received. The receipt is income only to the extent of the tax benefit or deduction derived from the loss taken in the closed year. If no benefit were obtained from any such deduction, the subsequent recovery of judgment for fraud in the sale transaction would include no income. There are evident distinctions between the *Dobson* case and the *McKean* case[47] discussed above, but new cases may arise in which it will be difficult to determine which or what rule should govern.

Interest. The includibility in gross income of interest on a personal-injury judgment already has been mentioned.[48] In several instances, too, the portion of a judgment labelled interest has been recognized as includable in gross income.[49]

PART II—ADVERSE JUDGMENTS

A litigant who has suffered an adverse judgment or made a payment in settlement of a suit does not *ipso facto* become entitled to an income tax deduction. Under the Internal Revenue Code of 1954, as under prior law, certain liabilities and payments are deductible and others are not; some items are deductible from gross income without reservation and others are deductible to a limited extent only.

Business expense. One of the best known deductions is that of business expenses. Section 162(a) of the present code provides that "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" are deductible.

It seems abundantly clear that a bus company should be permitted to deduct the amount paid in satisfaction of a judgment for personal injuries which were caused by the company in the course of its business. The Tax Court has so held.[50] However, in the case of an individual who paid a sum in settlement of a judgment obtained against him because of an automobile accident, the same court denied a deduction of the sum paid as a business expense since it appeared the vehicle was being used at the time of the collision on the business of the taxpayer's employer.[51] Had the accident occurred during a trip made in the course of the individual taxpayer's own business, the holding doubtless would have been otherwise.[52]

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[47] See note 38 *supra*.

[48] See notes 14 and 17 *supra*, and related text. *But see* Helvering v. Drier, 72 F.2d 75 (D. C. Cir. 1934) ("interest" plus payment by Mixed Claims Comm. did not equal basis of property taken).

[49] Kieselbach v. Commissioner, 317 U. S. 399 (1943) (interest on condemnation award); W. H. Kiser, 12 T. C. 178 (1949) (held no interest included in partition decree); Ollie Beverly Rose, 8 T. C. 854 (1947).

[50] Virginia Stage Lines, Inc., 16 T. C. 557 (1951).

[51] Emanuel O. Diamond, 19 T. C. 737 (1953).

[52] Anderson v. Commissioner, 81 F.2d 457 (10th Cir. 1936).

In the recent case of *Mid-State Products Co.*,[53] the corporate taxpayer was denied the deduction of a sum paid by it in settlement of a suit in which the corporation and its president were co-defendants. The suit, brought by a stockholder, had charged the president with mismanagement and "milking" of the corporation. Under the settlement, the president acquired the shares of the complaining stockholder. Accordingly, the court took the position that the taxpayer's payment was not made for corporate purposes or "in carrying on any trade or business" of the taxpayer. In another proceeding in which the corporate stake in a controversy involving the officer was shown to be greater, a different result was reached. [54]

A trustee who *personally* paid a sum of money in settlement of an action brought against a trust employee who had made a fatal attack on a third person was not permitted to deduct his payment either as a business expense or as a loss.[55] The payment was held not to be a business expense of the taxpayers personally. In the absence of a showing that reimbursement from the trust was impossible or impractical, the court was unwilling to allow the sum paid to be deducted as a loss.

In *Hales-Mullaly v. Commissioner*,[56] a corporate taxpayer paid out a considerable sum in settlement of a suit in which it was joined as a co-defendant with its organizers and promoters and a number of its employees. The suit charged fraud and a conspiracy to pirate the business of the camplainant-competitor. In addition to relying on the position that the payment did not relate to carrying on the taxpayer's business, the court of appeals said of the expenditure, "It is not ordinary."[57] The corporation's own liability, if any, was extraordinary, according to the court, in that it depended on the exceptional factor of the corporation's retention of the fruits of the fraud of others, to-wit, its organizers. In passing on the same facts and a similar question concerning state income taxes, the Oklahoma Supreme Court came to a contrary conclusion.[58]

That an adverse judgment in private litigation is based on fraud has been held insufficient, per se, to make the payment an extraordinary expense.[59] Indeed, not all penalties for public wrong-

[53] 21 T. C. 696 (1954).
[54] Catholic News Publishing Co., 10 T. C. 73 (1948).
[55] Charles D. Whitney, 13 T. C. 897 (1949).
[56] 131 F.2d 509 (10th Cir. 1942).
[57] *Id.* at 512.
[58] Protest of Hales-Mullaly, Inc., 186 Okla. 693, 100 P.2d 274 (1940).
[59] Helvering v. Hampton, 99 F.2d 358, 360 (9th Cir. 1935).

doing are denied deductibility. In 1954, the Commissioner of Internal Revenue finally agreed with the courts, or came close to agreeing with them, when he ruled that penalties for violations of OPA regulations are deductible if the violations were neither intentional "nor the result of the failure to take practical precautions."[60]

Nevertheless, it is fair to say that the words "more or less legal" have been interpolated into the above-quoted provisions of section 162(a) at some point by those who administer and apply that section.[61] For example, a payment made by a cement company in settlement of a non-civil antitrust proceeding brought against it by the State of Texas was held non-deductible as a business expense in *Universal Atlas Cement Co.*,[62] despite that taxpayer's denial of guilt in connection with the settlement. So also was a deduction denied in *William F. Davis, Jr.*[63] with respect to "insiders profits" paid to a corporation. Though a number of its members dissented in the *Davis* case, the Tax Court held that a deduction of such a payment, whether as a business expense or a loss, would frustrate a well-defined national policy.

In another case which involved "insiders profits" the taxpayer's obligation to disgorge was less clear but a payment was made in

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[60] Rev. Rul. 54-204, 1954-1 Cum. Bull. 49. But cf. Julain Lentin, 23 T. C. 112 (1954), *aff'd*, 226 F.2d 695 (7th Cir. 1955), *cert. denied*, 350 U. S. 934 (1956) (penalties for willful OPA violations held non-deductible). See generally Annot., 20 A. L. R. 2d 600 (1951).

[61] But cf. Commissioner v. Heininger, 320 U. S. 467 (1943); Commissioner v. Doyle, 231 F.2d 635 (7th Cir. 1956).

[62] 9 T. C. 971 (1947), *aff'd per curiam*, 171 F.2d 294 (2d Cir. 1948), *cert. denied*, 336 U. S. 962, (1949).

[63] 17 T. C. 549 (1951).

settlement of the possible liability. In this case, the Tax Court was willing to allow a deduction of the payment either as an expense or a loss.[64] In *Commissioner v. Macy,*[65] the beneficiaries of certain testamentary trusts filed objections to the accounts which the taxpayers, as trustees, had presented for judicial approval. There was no charge of bad faith. Without admitting liability but in order to settle the contested matters, the taxpayers consented to a surcharge of their accounts and placed personal funds, in an amount equal to the surcharge, to the credit of the principal accounts of the trust estates. The payment was held deductible as a business expense both by the Tax Court and on appeal.

Capital expenditure.[66] In the last of the foregoing cases one of the rejected arguments of the Commissioner was that the payment credited to the principal of the respective trusts was a capital expenditure and thus not deductible. In another recent case the Tax Court overruled a government contention that a payment made in settlement of a suit for commissions, damages for breach of contract, and similar items, actually represented the purchase price of an interest in a patent.[67]

The Commissioner is more likely to favor the position that a

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[64] William L. Butler, 17 T. C. 675 (1951).
[65] 215 F.2d 875 (2d Cir. 1954). Accord Great Island Holding Corp., 5 T. C. 150 (1945).
[66] What constitutes a capital expenditure, like what constitutes a capital recovery, a question discussed in Part I, pertains to the whole income tax system, the entire code rather than any particular section. This is tantamount to saying that the distinction between income and capital and between capital expenditure and revenue charges entails recourse to what may be called "the common law of taxes."
[67] Camloc Fastener Co., 10 T. C. 1024 (1948).

payment is a capital expenditure than is the taxpayer. Such was the situation in the cases just mentioned.[68] However, in *James E. Caldwell & Co.*[69] it was the petitioner which wanted to have one of its payments so classified. The payment in question had been made in settlement of a suit which had been brought against the taxpayer by a judgment-creditor of its president for the purpose of setting aside an alleged fraudulent conveyance. The Tax Court held, with several members of the court dissenting, that the taxpayer could not add the payment to the basis of the property for the purpose of computing a gain on the sale of the property.

Non-business expense. In *Samuel G. Swaim*[70] a taxpayer had paid part of a commission claimed by a real estate broker, but had done so without admitting liability, merely to avoid litigation. The Tax Court held that the sum so paid was spent to conserve property and so was deductible as a non-business expense. The language of the governing section of the current code, section 212, corresponds with that of the prior law except that it has been broadened to provide expressly for the deduction of certain expenses relating to taxes. Section 212 provides:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection or refund of any tax.[71]

In a case in which the facts were essentially similar to those in the *Macy* case discussed above, the taxpayer claimed a deduction as a non-business expense. The Tax Court's decision granting the deduction was reversed on appeal by the same appellate court which later considered the *Macy* case.[72] In the latter case the court of appeals did not overrule its prior decision expressly, it at all, but distinguished the two cases on the basis of the section of law invoked by the respective taxpayers. However, it would seem more reasonable, in the ordinary case of a non-professional trustee (as all these appear to have been), to grant such a deduction as a non-business expense and to disallow it, if at all, as a business expense.

A taxpayer who purchased a release of a claim made against him under the warranty provisions of a deed was denied the right to deduct the payment either as an ordinary loss or as a non-business expense.[73] The Tax Court held the payment was deductible only in the limited way prescribed for capital losses. The transaction of sale and conveyance which had occurred a few years earlier than

[68] See also Levitt & Sons, 5 T. C. 913 (1945), *aff'd per curiam*, 160 F.2d 209 (2d Cir. 1947).

[69] 24 T. C. 597 (1955).

[70] 20 T. C. 1022 (1953).

[71] Int. Rev. Code of 1954, § 212.

[72] Julius A. Heide, 8 T. C. 314 (1947), *rev'd*, 165 F.2d 699 (2d Cir. 1948). For discussion of the general relation between business and non-business expense, see Bingham Trust v. Commissioner, 325 U. S. 365 (1945).

[73] Estate of James M. Shannonhouse, 21 T. C. 422 (1953). But cf. Samuel G. Swain, 20 T. C. 1022 (1953).

the payment aforesaid was capital in nature and, according to the holding of the court, imparted its character as such to the adjustment made under the warranty contained in the deed.

Capital loss. In the case just described the court relied on the holding of the Supreme Court in the *Arrowsmith* case.[74] In the latter case, the taxpayer had paid a judgment given against a liquidated corporation of which he was a transferee. Several years earlier, at the time of the liquidation and in connection with it, the taxpayer had reported a capital gain and had paid the tax for the year accordingly. The Tax Court had considered the payment of the judgment as a fully deductible ordinary loss. The Supreme Court differed. In a decision from which three justices dissented the Supreme Court held that the loss fell squarely within the definition of "capital losses" contained in the sections pertaining to such losses—the necessary sale or exchange presumably being the one which had occurred for tax purposes at the time of the liquidation. This view of the situation meant a much smaller deduction for the taxpayer than would have been allowed under the ruling of the Tax Court.

Some years before, the Supreme Court had held that a capital loss occurred when a vendee's interest in real estate constituting a capital asset was cut off by a foreclosure sale.[75] According to the Court, the sale on foreclosure, though involuntary, was a sale within the meaning of the capital-loss provisions then in force. Moreover, the sale rather than the decree on foreclosure was held to be the definitive event establishing the loss. The principle of the case doubtless is broad enough to cover the ordinary foreclosure of mortgagors' interests in capital assets.

Ordinary loss. In many instances a losing litigant or other taxpayer seeking to deduct a judgment or other payment makes the alternative claim that it is either an expense or an ordinary loss. Whenever either type of deduction is allowable at all, it is allowable in full, but, as would be expected, the respective sections differ in language and to some extent in coverage. The text of section 165 of the current code resembles that of prior provisions and, so far as here pertinent, reads as follows:

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[74] Arrowsmith v. Commissioner, 344 U. S. 6 (1952). For current capital loss provisions see Int. Rev. Code of 1954, § § 1211-12 & 1222.

[75] Helvering v. Hammell, 311 U. S. 504 (1941).

In the case of an individual, the deduction under section (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.[76]

While there is no express statutory limitation on the losses deductible by corporations, certain limitations have been implied. For a reason not explained in the court's opinion, the facts of the Hales-Mullaly case discussed above did not justify an ordinary loss deduction. It may be, as a subsequent Tax Court decision implies, that an essential condition for deducting a corporate loss resulting from a settlement is an approved degree of relationship between the corporate business and the loss.[77] Moreover, as in the case of an expense, an ordinary loss deduction appears subject to the implied condition that it is not generally allowable, either to an individual or to a corporation, with respect to an adjudged fine, penalty or the like.[78]

At times, as indicated earlier, an ordinary loss deduction may be denied on the ground that the loss in question is more appropriately described by the statutory provisions relating to capital losses.[79]

SUMMARY

The foregoing, of course, is no more than introduction to certain common phases of the law of federal income taxes. It is hoped, however, that the elementary nature of the study will be one of its chief merits. To suggest solutions for all likely situations, even if possible, would be to place the cart before the horse. In tax law as elsewhere, the solution of a specific problem depends upon its recognition and that in turn is conditioned upon an understanding of the general nature of the various types of problems which have been, and thus may be, encountered in litigation. If the present article contributes to such an understanding—to such a recognition of problems and possibilities—it has served its purpose. Particular solutions, like heaven, can wait. Besides, something should be left to litigation!

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[76] Int. Rev. Code of 1954, § 165.

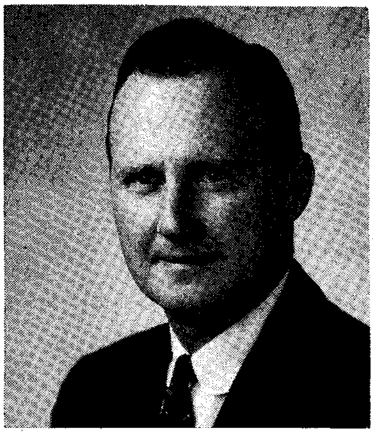
[77] James E. Caldwell & Co., 24 T. C. 597 (1955) (2d question presented).

[78] See notes 60, 61, 62 and 63 *supra*, and related text. Cf. United States v. Algemene Kuntzijde Unie, N. V., 226 F.2d 115 (4th Cir. 1955) deduction of loss denied as contrary to national policy); Fuller v. Commissioner, 213 F.2d 102 (10th Cir. 1954) (loss deduction denied because of state policy).

[79] It should be noted, too, that the ordinary loss and bad debt provisions are mutually exclusive. Spring City Foundry C. v. Commissioner, 292 U. S. 182 (1934). A non-business bad debt results in a capital loss. Int. Rev. Code of 1954, § 166 (d). Cf. Thomas Lonergan Trust, 6 T. C. 715 (1946) (unusual question whether payment of a judgment against a decedent was deductible by the trustee as currently distributable income reportable by the beneficiary under the provisions relating to trusts; deduction disallowed).

SECONDARY DISTRIBUTIONS OF SECURITIES

By Leland E. Modesitt



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The emphasis which has been placed upon the qualification of public offerings of securities by issuing corporations, known as primary distributions, has tended to obscure the problems which arise after the completion of such offerings. A large part of what has been said and written to explain the "latent ambiguities" of federal and state securities laws deals with the obligations of an issuer in quest of public financing. The insider in quest of public financing stays backstage, well beyond the footlights where he may, if he is so inclined, unobtrusively change the scenery.

Generally speaking, a secondary distribution is a distribution by persons other than the issuer of securities. A distribution, as the name implies, involves indiscriminate sales of a substantial amount of securities and not a few sporadic, restricted transactions. Thus, offerings by large stockbrokers such as promoters, officers, directors, trusts and insurance companies usually constitute secondary distributions.

It is a common practice to issue substantial amounts of stock to promoters in exchange for properties and services, prior to the solicitation of the public for required corporate financing. When the primary offering is made by the corporation the prospectus or offering circular discloses the nature of the properties and business and how much promotional stock there is in relation to the shares sold for cash. Hence, the buyer is in a position to consider how much "water" there is, and whether the issue is relatively attractive at the stated offering price.

The promoters, officers and directors generally hold their shares until the corporation's public financing has been completed. At least they are fairly discreet about any sales made during this period. Although this is required by law where the primary offering has been made pursuant to Regulation A,[1] there is a sound

[1] 17 C. F. R. § 230. 251-62 (Supp. 1957).

business reason in that concurrent sales by insiders would undermine the primary distribution of the issuer. After the primary offering has been completed and a market for the shares so distributed has been established, most insiders can never be completely indifferent to the market situation. The amount, and the time when they sell varies according to individual conceptions of legal restrictions, the inherent value and growth potential of the shares, the desire for immediate cash funds and various other factors, but sooner or later these promotional shares reach the market.

The provisions of the Securities Act of 1933[2] with respect to the sale of securities by an issuing corporation are reasonably explicit; but, considering that some control of sales by affiliates is equally in the public interest, the statutory provisions applicable to such transactions are remarkably devious. These provisions are:

> Sec. 4. [Exempted Transactions] (1) "Transactions by any person other than an issuer, underwriter, or dealer; transactions by an issuer not involving any public offering; or transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except transactions taking place prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter and transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days after the first effective date of such registration statement or prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such forty days any time during which a stop order issued under section 8 is in effect as to the security), and except transactions as to securities constituting the whole or part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through the underwriter."

[2] 48 Stat. 74, 15 U. S. C. § § 77 (a) to (aa) (1952).

(2) "Brokers' transactions, executed upon customers' orders on any exchange or in the open or counter market, but not the solicitation of such orders."

. . .

Sec. 2 (4) "The term 'issuer' means every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions) or of the fixed, restricted management, or unit type, the term 'issuer' means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity; except that with respect to equipment-trust certificates or like securities, the term 'issuer' means the person by whom the equipment or property is or is to be used and except that with respect to fractional undivided interests in oil, gas, or other mineral rights, the term 'issuer' means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering."

. . .

Sec. 2 (11) "The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. *As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.*"[3]

[3] *Ibid.* Emphasis supplied.

As in the case of many problems arising under this federal law, it is impossible to weave the statutory provisions into a categorical rule governing all sales by insiders. A number of factors remain undefined. What constitutes "distribution," "direct or indirect participation" or "direct or indirect common control" under section 2 (11)? Does section 4 (2) mean what it says, and if so, what constitutes an unsolicited order?

In the Matter of Thompson Ross Securities Co.,[4] it was held that the president of a corporation who owned 18% of the outstanding stock and who had managed and formulated policies for the corporation for over ten years was a controlling person, and a dealer purchasing from him was held to be an underwriter under section 2 (11). In discussing the question of control the Commission stated:

> "The question of 'control' is a factual question. 'Control' is not synonymous with ownership of 51% of the vot-

[4] 6 S. E. C. 1111 (1940).

ing stock of a corporation. Where power exists to direct the management and policies of a corporation, 'control' within the meaning of Sec. 2 (11) exists even though the persons who possess that power do not own a majority of the corporation's voting stock."[5]

Possibly the most controversial case involving a number of the problems of secondary distributions was *In the Matter of Ira Haupt and Co.*[6] From December 15, 1943 to June 1, 1944 Ira Haupt and Co., a New York Stock Exchange firm, sold approximately 93,000 shares of the common stock of Park and Tilford Inc., on behalf of the Schulte interests, who together owned some 91% of the outstanding stock. On December 15, 1943, when the market price of the stock was about $57, Schulte publicly announced that Park and Tilford, Inc., was considering a distribution of whiskey to its shareholders at cost. Following the announcement the price steadily advanced to a high of 98¼ on May 26, 1944. On that day Park and Tilford, Inc., offered to sell to its stockholders at a reduced price six cases of whiskey for each share of stock. On May 31, 1944, the Office of Price Administration limited the negotiability of the purchase rights and the maximum profits on resale of the liquor. The price of the stock dropped 10⅛ points that day and reached a low of 30⅝ in June. During this period the Haupt firm transacted all sales for Schulte over the New York Stock Exchange. The sell orders commenced with 200 or 300 share blocks but within three months the firm was authorized to sell up to 50,000 shares at 80 or better. It was stipulated that during the period of five and a half months when the 93,000 shares were sold, approximately 89,000 had been sold without any solicitation.

In an administrative proceeding against the Haupt firm it was argued that the transactions were exempt as broker's transactions under section 4 (2). One of the principal contentions of Haupt was that a precise number of shares to be publicly dispersed is an essential element of a distribution.

The Commission had no trouble tying the Haupt firm into the violation. It stated: "Nor do we think that a distribution loses its character as such merely because the extent of the offering may depend upon certain conditions such as market price."[7] The Com-

[5] *Id.* at 1119. See also S. E. C. v. Kaye Real & Co., 122 F. Supp. 639 (S. D. N. Y. 1954).
[6] 23 S. E. C. 589 (1946).

mission also rejected the firm's claim that it was not aware of the distribution intended by the Schulte interests. The Commission pointed out that only 7,000 shares of the stock had been traded on the exchange in the entire month of November; that 24,500 shares had been traded in the first two days following the announcement of the impending whiskey dividend; and that an additional 115,000 shares had been traded during the rest of that month. Under all the circumstances the Commission found that the only reasonable conclusion that could have been reached was that it was intended that a large block would be sold.

Haupt also contended that substantially all sales were unsolicited transactions within the section 4 (2) exemption, but the Commission stated:

> "We conclude that Section 4 (2) cannot exempt transactions by an underwriter executed over the Exchange in connection with a distribution for a controlling stockholder. Respondent has suggested that this conclusion is contrary to administrative interpretations issued by our staff and to the implications in recent orders issued in connection with applications of *The United Corporation* under the Public Utility Holding Company Act with respect to United's sale of common stock of a subsidiary through brokers on the New York Stock Exchange. The administrative interpretations referred to were to the general effect that an underwriter selling for a controlling stockholder over the ex-

[7] *Id* at 600.

change might conceivably be entitled to the exemption under Section 4 (2) if his activities were confined strictly to the usual brokerage functions, but that, as a practical matter, his activities could not be so confined in connection with a distribution of any substantial block of securities. These interpretations arrived at the same ultimate result as that which we have reached here. But the theory and the qualification of the interpretation—which we agree are inconsistent with our conclusion herein—were developed against the background of a very different market than is now prevalent. It has been only comparatively recently that the problem has been presented in the context of a market in which large blocks can frequently be sold without solicitations or other sales activity. In that context, the invalidity of the theory on which the interpretations were based has become apparent. We have reached our present conclusion on this phase of the case after careful consideration of the entire problem and, to the extent that the administrative interpretations referred to and the principle involved in the *United* case may be inconsistent with that conclusion, they must be overruled."[8]

The United Corporation was a public utility holding company order to divest itself of the stock of operating subsidiaries under the Holding Company Act. Between December, 1945 and May, 1946, it sold on the New York Stock Exchange 600,000 shares of common stock of its subsidiary, Columbia Gas & Electric Company. An exemption under section 4 (1) & (2) was assumed from the Commission's silence, because there was clear control and no registration statement.

The above quoted excerpt from the *Haupt* case served to support the view of the securities industry that the Commission's inaction on the United Corporation offering, which was a secondary distribution if there ever was one, was consistent with the policy it had theretofore followed to the effect that unsolicited trans-

[8] *Id.* at 607. The proceeding against Haupt was based upon § 15 (b) of the Exchange Act of 1934, which provides for the revocation of the registration of a broker dealer for a willful violation of the 1933 act and the regulations and rules thereunder as well as for other reasons. The Commission found that there had been a willful violation of the 1933 act but withheld revocation of the license because the Commission had reversed its previous position on the § 4 (2) exemption. The Nat'l Ass'n of Security Dealers followed this up with a twenty day suspension.

actions for an affiliate of the issuer did not make the broker an underwriter notwithstanding that he was selling for an issuer within the meaning of section 2 (11). Thus, under this policy the broker's part of the transaction was exempt under section 4 (2) and the affiliate's part of the transaction was exempt under section 4 (1) because the affiliate was not an issuer, underwriter or dealer.

The Commission's remarks about the *United* case were unfortunate. It is rather difficult to accept the explanation that the administrative interpretations (which apparently prevailed as late as 1946 in favor of United Corporation) "were developed against the background of a very different market" from that which existed at the time of the *Haupt* case, considering that the *Haupt* sales occurred almost two years prior to the *United* sales. In several cases prior to *Haupt* it was clearly stated that dealers purchasing from controlling stockholders with a view to distribution, as well as persons selling for such stockholders in connection with the distribution, are "underwriters."[9]

The *Haupt* case was consistent with established precedent. The *United* case was no part of such precedent. It was an exception. Perhaps the exigency of divestment under the Holding Company Act of 1935[10] justified the exception, but the Commission in the *Haupt* case, rather than climbing back over this thorny limb simply sawed it off.

In any event the *Haupt* case clearly pointed up the precarious position of a selling affiliate and his broker. Where would the line be drawn between the egregious transactions of the Schulte interests and the case of Assistant Secretary Joe Pumpernickel, who has waited three years to sell a few shares of Uncompagre Oil, Inc.?

In 1951 the Commission promulgated Rule 154 which provides: "Definition of Certain Terms Used in Section 4(2)

> (a) The term 'brokers' transactions' in Section 4 (2) of the Act shall be deemed to include transactions by a broker acting as agent for the account of any person controlling, controlled by, or under common control with, the issuer of the securities which are the subject of the transactions where—
>
> (1) The broker performs no more than the usual and customary broker's function,

[9] In the Matter of Resources Corp. Internat'l, 7 S. E. C. 689 (1940); In the Matter of Thompson Ross Securities Co., 6 S. E. C. 1111 (1940); In the Matter of Sweets Steel Co., 4 S. E. C. 589 (1939); SEC v. Saphier, 1 S. E. C. Jud. Dec. 291 (1936).

[10] 49 Stat. 838, 15 U. S. C. §§ 79 (a)-(z) (6) (1952).

(2) The broker does no more than execute an order or orders to sell as a broker and receives no more than the usual or customary broker's commission, and the broker's principal, to the knowledge of the broker, makes no payment in connection with the execution of such transactions to any other person.

(3) Neither the broker, nor to his knowledge his principal, solicits or arranges for the solicitation of orders to buy in anticipation of or in connection with such transactions, and

(4) The broker is not aware of circumstances indicating that his principal is an underwriter in respect of the securities or that the transactions are part of a distribution of securities on behalf of his principal.

(b) For the purpose of paragraph (a) of this Rule, the term 'distribution' shall not apply to transactions involving an amount not substantial in relation to the number of shares or units of the security outstanding and the aggregate volume of trading in such security. Without limiting the generality of the foregoing, the term 'distribution' shall not be deemed to include a sale or series of sales of securities which, together with all other sales of securities of the same class by or on behalf of the same person within the preceding period of six months, will not exceed the following: (1) if the security is traded only otherwise than on a securities exchange, approximately one percent of the shares or units of such security outstanding at the time of receipt by the broker of the order to execute such transactions or (2) if the security is admitted to trading on a securities exchange the lesser of approximately (A) one per cent of the shares or units of such security outstanding at the time of receipt by the broker of the order to execute such transactions or (B) the largest aggregate reported volume of trading on securities exchange during any one week within the four calendar weeks preceding the receipt of such order.

(c) The term 'solicitation of such orders' in Section 4 (2) of the Act shall be deemed to include the solicitation of an order to buy a security, but shall not be deemed to include the solicitation of an order to sell a security.

(d) Where within the previous 60 days a dealer has made a written bid for a security or a written solicitation of an offer to sell such security, the term 'solicitation' in Section 4 (2) shall not be deemed to include an inquiry regarding the dealer's bid or solicitation."[11]

As a practical matter, this rule afforded very little relief. It codified the conclusions reached in the *Haupt* case, including certain subjective tests, such as the broker's knowledge of his principal's activities, and provided a laborious formula for determining what transaction shall be deemed not to constitute a "distribution" by a selling stockholder.

[11] 17 C. F. R. 230.154 (Supp. 1957).

The availability of the section 4 (2) exemption remains a complex question of fact with respect to which the broker and the selling stockholder must act as their judgment dictates. Now that the Regulation *A* exemption is not available for secondary offerings by stockholders of newly organized corporations the restraint of conscience may well diminish.

In practice insiders generally observe a minimum holding period of one year to establish the requisite initial intention of purchasing from an issuer for investment and not with a view to distribution. Such intention is not established *ipso facto*, but by that time many corroborative circumstances can be established. The holder of investment stock by reason of promotional services rendered may divorce himself from management, or may sell in small blocks to meet unanticipated financial reversals. The business and purposes of the issuer may change drastically. There may be a merger which disrupts the original corporate plans and dilutes the control attributable to ownership of equity securities.

Selling unregistered securities allegedly taken for investment, even where the seller is not in common control of the issuer, is not without some risk to both principal and dealer,[12] but experience indicates that the risk is largely theoretical. Assuming there is no

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[12] The General Counsel of the Commission received an inquiry whether a dealer might resell to the public, without registration, a block of securities bought from an initial purchaser who had acquired the securities in connection with a "private offering." Part of his reply, with respect to the matters above discussed, reads: "I call your attention to my opinion set out in the next to the last paragarph of Release No. 285, which states in substance that the answer to your question depends upon whether the initial purchaser acquired the securities with a view to distribution, and further points out that if his acquisiton was wth such intent, he would be an underwriter, so that in general sales by dealers of securities bought from him would not be exempt from registration.

"You will appreciate that the intent of the initial purchaser at the time of the acquisition is a question of fact upon which I can express no opinion.

"I wish to make clear, however, that I do not believe the fact that the initial purchaser has stated that his original purchase was for investment and not for resale is necessarily conclusive on this question. In my opinion there should be considered such other factors as: (1) the relation between the issuer and the initial purchaser; (2) the business of the latter, as for example, whether such purchaser is an underwriter or dealer in securities, and, if not, whether the purchase of such a block of securities for investment is consistent with its genearl operations; and (3) the length of time elapsing between the acquisition of the securities by the initial purchaser and the date of their proposed resale.

"Of course, if the securities in question were in fact purchased by the initial purchaser for investment rather than for resale, dealers' sales thereof to the public would not necessitate registration under the Securities Act.

"In conclusion, I feel that I should point out that even though a dealer is satisfied that a particular block of unregistered securities was bought by an initial purchaser for investment, he nevertheless takes the risk that, if his determination is incorrect sales by him of such securities will be in violation of the registration requirements of the Act."—Op. of Gen'l Counsel, SEC Release No. 603 (Class C), 11 Fed. Reg. 10955 (1935).

fraud (fraud being difficult to prove in the absence of flagrant market manipulations) the Commission may do no more than investigate and enjoin the selling stockholder, and in the case of a broker or dealer it may take disciplinary action under section 15 (b) of the Exchange Act,[13] if it can prove a *willful* violation.[14] The purchaser can invoke the civil liability provided by section 12 (1) of the Securities Act, but usually, in relation to the amount involved, the time and expense incurred in such proceedings are substantial, not to mention the problems of discovery encountered in an action based upon a secondary distribution.

The rash of mergers and consolidations in recent years, particularly in the case of promotional companies has not been without Securities Act ramifications. Mergers are carried out under the "no sale theory" pursuant to Rule 133 which provides:

> "For purposes only of Section 5 of the Act, no 'sale,' 'offer to sell,' or 'offer for sale' shall be deemed to be involved so far as the stockholders of a corporation are concerned where, pursuant to statutory provisions in the state of incorporation or provisions contained in the certificate of incorporation, there is submitted to the vote of such stockholders a plan or agreement for a statutory merger or consolidation or reclassification of securities, or a proposal for the transfer of assets of such corporation to another person in consideration of the issuance of the securities of such other person, under such circumstances that the vote of a required favorable majority (1) will operate to authorize the proposed transaction so far as concerns the corporation whose stockholders are voting (except for the taking of action by the directors of the corporation involved and for compliance with such statutory provisions as the filing of the plan or agreement with the appropriate state authority), and (2) will bind all stockholders of such corporation except to the extent that dissenting stockholders may be entitled, under statutory provisions or provisions contained in the certificate of incorporation, to receive the appraised or fair value of their holdings."[15]

This rule is not to be confused with section 3 (9) of the Securities Act which exempts from registration any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid for soliciting such exchange. Hence the statutory provision is limited to situations where the securities surrendered and those taken in exchange are both issued by the same corporation.

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[13] 49 Stat. 1380 (1934), 15 U. S. C. § 78 (1952).

[14] *In the Matter of Thompson Ross Securities Co.*, 6 S. E. C. 1111 (1940), the Commission found a dealer had willfully violated §§ 5 (a) & 17 (a) (2) of the Securities Act in effecting sales by use of a prospectus which stated that the stock was being sold at the market and which failed to state that 60% of the outstanding stock was restricted from transfer, which operated as a restraint upon market action. In the circumstances, the dealer's reliance upon advice of counsel was held to be no defense to the charge of "willfull" violation.

[15] 17 C. F. R. 230.133 (1957 Supp.). On October 2, 1956 the Commission announced a proposed revision of Rule 133. (Securities Act Release No. 3698). In effect it would rescind the existing Rule 133 and substitute therefor a rule which would define an "offer" to include the solicitation of a vote, consent of authorization of stockholders of a corporation in favor of such mergers, consolidations, reclassifications of securities and transfers of assets. Under the revised rule a "sale" would be deemed to occur when the approval of stockholders to such corporate action occurs.

An implicit condition of Rule 133 is a bona fide corporate purpose. It was not intended merely as a device for affecting an unregistered secondary distribution, notwithstanding the more than occasional efforts to so use it. In *SEC v. Micro Moisture Controls, Inc.*,[16] it was held that section 4 (1) and Rule 133 of the Securities Act of 1933 were inapplicable to an exchange of stock of one corporation for assets of another corporation where the acquiring corporation was controlled by stockholders of the acquired corporation and the exchange was merely a step toward the public sale of stock issued in exchange. The court found that the persons who were selling the stock controlled the issuer, since they had the power to direct its policies and to obtain the required signatures on a registration statement.

Also, contrary to a rather popular misconception, securities issued pursuant to a Rule 133 transaction do not automatically acquire an exempt status. In the jargon of the brokerage fraternity this misconception is referred to as "freeing-up front end stock by a merger or consolidation." *In the Matter of Thompson Ross Securities Co.*, mentioned above, it was contended by a registered broker dealer that securities issued under section 3 (a) (9) are forever exempted from registration. In holding against this contention the Commission stated:

> "Unlike securities which fall within Sec. 3 (a) (2) to 3 (a) (8) inclusive, of the Act, there is nothing in the intrinsic nature of securities falling within Sec. 3 (a) (9) which justifies their permanent exemption from registration. The basis of the exemption under Sec. 3 (a) (9) is merely the circumstances surrounding the issuance of securities. The sale to the public of a large block of securities previously exempted from registration when they were exchanged for other securities possesses all of the dangers attendant upon a new offering of securities to the public by the issuer. Section 3 (a) (9) does not therefore permanently exempt securities offered in a transaction of exchange."[17]

This holding is equally applicable to merger exchanges pursuant to Rule 133.

16 148 F. Supp. 558 (S. D. N. Y. 1957).
17 6 S. E. C. at 1118.

Assuming that the merger, consolidation, reclassification or transfer of assets is motivated by a bona fide corporate purpose it should be noted that Rule 133 begins, "For purposes of Section 5 only. . . ." Thus stock issued in reliance thereon is exempt from registration only.

The Colorado and Delaware statutes on merger and consolidation, which are more or less standard, contain no specific requirements about the information to be set forth in the proxy statement. It is not an uncommon practice to submit the merger proposal without financial statements and with very little factual data. Frequently, the stockholders of the constituents are only told how many shares they will exchange for each share of the continuing corporation, and the approximate market value of each. Such facts as assumed liabilities, outstanding stock purchase options, management contracts, fees and costs of the merger, royalty burdens on properties to be acquired and other material facts may not be mentioned. As this is the type of omission and half truth prohibited by section 17 (a) of the Securities Act of 1933 and Rule X 10 (B) (5)[18] under the Securities Exchange Act of 1934, it was believed that there would be no serious abuse of the section 5 exemption pursuant to the "no sale" theory. Moreover, companies with listed securities are also subject to the detailed proxy regulations adopted pursuant to section 14 of the Exchange Act. Rule X 14 (A) (9)[19] requires that proxy statements contain a full disclosure of material facts.

Experience under Rule 133 indicates that this view was highly sanguine. It became apparent under the Investment Company Act of 1940[20] to which the "no sale" rule was extended shortly after its enactment that there was insufficient protection to shareholders against consolidation of affiliated companies on unequal terms. Section 17 (a) of the Investment Company Act prohibits sales of assets or securities between corporations controlled by a registered investment company, unless the sales have been approved as fair and equitable by the commission.

In *Phoenix Security Corp.*,[21] two corporations controlled by a registered company decided to merge. The Commission decided that

[18] 17 C. F. R. 240.10 (b) (5) (1949).
[19] *Id.* at 240.14 (a) (9).
[20] 54 Stat. 847, 15 U. S. C. § § 80 (a) (1)-(52) (1952).
[21] 9 S. E. C. 241 (1941).

since the definition of the word "sale" in the Investment Company Act is practically the same as in the Securities Act, the "no sale" rule should be held applicable to the transaction in question and, hence, the terms of the merger did not have to be approved. Under such literal interpretation, two affiliates controlled by a third might well decide to merge on unfair and inequitable terms, and minority shareholders would have as little protection as in case of a conventional sale of securities between the companies. In 1953, the Commission reversed the *Phoenix* case stating that continued experience under the Investment Company Act demonstrated that application of the "no sale" theory to section 17 thereof tended to defeat the legislative purpose of that section.[22]

One of the few cases involving an alleged civil liability grounded upon a merger transaction is *National Supply Co. v. Stanford University*.[23] Denial of recovery was based primarily on the stockholder's negligence in failing to make timely objection to the plan of consolidation. The contention that the proxy statement was misleading was rather summarily disposed of by the court. Stanford argued that it was led to believe that it might retain its preferred stock, nothwithstanding the consolidation, and that it was not advised of its right by a timely objection to claim the appraised value of its shares. The court said that a dissatisfied stockholder should be held to a degree of diligence in informing himself of, and in asserting, his rights.

> "He may not by inaction speculate upon the outcome of the merger. He is not permitted to plead ignorance of the law of the state of incorporation if he has negligently failed to inform himself thereof. He may not unreasonably delay the bringing of suit, either for the value of his shares or for equitable relief against what he claims is an unfair merger, to the prejudice of existing shareholders or those who may become such in the interim."[24]

The court stated that certain of the findings of the trial court (which had held in Stanford's favor) indicated that the trial court was influenced by the contention that the Securities Act of 1933 had been violated. However, since the SEC had filed a brief *amicus curiae* indicative of its view that the consolidation did not involve a "sale" of securities, and that the civil liabilities provisions of the Act were inapplicable, the court considered neither the questions of section 5 violation nor possible violations of section 17 (a) or Rule X 10 (B) (5). It merely concluded "Without going into the matter, we may say that we are in accord with the views of the Commission."[25]

Whatever the respective merits and defects of the proposed revision of Rule 133 may be, it must be considered in the light of an era of numerous facile mergers and consolidations.

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[22] In the Matter of E. I. Dupont Investment Co., Act Release No. 1837 (1953), C. C. H. Fed. Sec. Law Rep. P. 76, 213.
[23] 134 F.2d 689 (9th Cir.), *cert. denied*, 320 U. S. 773 (1943).
[24] *Id.* at 692.
[25] *Id.* at 694.

COLORADO STATUTES—SOME CHANGES MADE BY THE FORTY-FIRST GENERAL ASSEMBLY

By Charles S. Thomas

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The forty-first general assembly passed 316 bills in its ninety-day session. At least fifteen were vetoed by the governor. A large number became law when signed. The rest, with only a few exceptions, became law on May 2, 1957.

Of interest is House Bill 206 which allows persons, private entities and political subdivisions to sue the state or any of its departments, commissions or officers for damages caused by failure of the Georgetown dam. Of particular interest, but unfortunately, only in passing, are House Bill 278 which reorganizes the state's supervisory machinery for banks and rewrites a considerable portion of the banking laws, and House Bill 236 which makes changes in the Blue Sky Law and the Fraudulent Practice Act concerning securities.

Most of the bills treated here amend or change existing law. We intend to spotlight the changes. Where possible, effective dates of bills which become law at various times after May 2, 1957, are furnished.

ANNULMENT

House Bill 77 sets forth seven specific situations in which a marriage is voidable. The operation, procedure and effect under the first one, "nonage," are virtually unchanged. The remaining six are substantially the conditions making marriages voidable at common law. The bill provides that an action for annulment will lie if brought within one year after discovery of the existence of grounds therefor, unless there has been ratification by acquiescence. It empowers the court to determine marital status and enter its decree annuling a voidable marriage or declaring a marriage to be void. In addition, it provides for the entry of orders for custody and child support, suit money, costs and any other matters in controversy, and for a procedure in the event one party is mentally incompetent. Divorce and annulment actions cannot be combined. It does not apply to actions begun prior to its effective date, July 1, 1957.

CITIES AND TOWNS

Senate Bill 236 includes school districts, municipalities, and other political subdivisions under the term "landowner," thus removing a definite obstacle to their annexation to cities and towns.

Disconnection. House Bill 118 provides that disconnected territory shall continue to be subject to certain zoning regulations of its former municipality for a period of six years after disconnection.

Eminent Domain. Senate Bill 232 authorizes a city, in certain cases, to proceed under either the article relating to eminent domain by cities or the general article thereon.

Exclusion from Water Conservation Districts. House Bill 243 authorizes cities and towns included in water conservation districts against their expressed wishes to withdraw therefrom.

CONVEYANCES

Sworn Certificates. Senate Bill 222 requires, with certain exceptions, that a sworn certificate in duplicate be submitted with each deed conveying an interest in real estate. The certificate shall state the total consideration paid, the relationship or other close connection, if any, existing between the grantor and the grantee and such other information as may be required by the Colorado Legislative Council. A fee of one cent for each $100 of consideration is charged the seller. This bill becomes effective July 1, 1957.

CORONERS

Four bills[1] collectively change the present law concerning the duties of coroners and deputy coroners in cases of death without medical attendance and death under suspicious circumstances. Notice of death is to be given directly to the coroner who is to notify the district attorney before proceeding, with the inquest or investigation. If either the coroner or the district attorney deems it advisable, the coroner is required to cause a post mortem examination to be made by a licensed physician. Coroners are authorized to summon licensed physicians and to provide for their compensation. Deputy coroners are authorized to act in place of coroners at all times, instead of only during the coroner's absence, incapacity or unavailability.

COUNTY OFFICERS

Suspension and Removal. Boards of county commissioners are now empowered to suspend a county official found guilty of a felony or infamous crime and to reinstate with back pay or discharge him depending on the outcome of the last appeal that is taken.[2]

County Treasurers—Fees. Henceforth, according to this law, county treasurers will charge no fees for keeping their records of tax sales, but will be allowed reasonable compensation for this service by their county commissioners.[3]

COURTS

Insanity Pleas. The trial court is given discretion to determine whether all of the issues should be tried together or whether the insanity plea should be tried separately.[4]

Judgment Within Ten Days. On failure of the justice of the peace in a criminal action to enter his judgment or decision within ten days after trial, the defendant, on motion, is entitled to a dismissal.[5]

Penitentiary or Reformatory—Sentence. Senate Bill 19 gives criminal courts the discretion of sentencing persons between sixteen and twenty-five years of age who are convicted of a felony to either the reformatory or the penitentiary, except in convictions

[1] House Bills 88, 90, 91 & 92.
[2] Senate Bill 29.
[3] Senate Bill 165.
[4] Senate Bill 221.
[5] House Bill 46.

involving life imprisonment, first and second degree murder, and cases where the person convicted has been previously convicted of a felony. Excludes from the effects of this act the statutes concerning probation and sex offenders.[6]

Suspension of Fines and Stays of Execution. House Bill 182 authorizes police magistrates, municipal judges, and justices of the peace to suspend "any or all parts of the fine accrued or jail sentence imposed, or both, and to grant a stay of execution not to exceed thirty days, on any fine accrued or jail sentence imposed, or both."

CRIMES

Burglary. An amendment changes the definition of "burglary" by removing the word "maliciously," by providing that the entry be made into a portion of a "building" or "trailer," and by eliminating the various names for structures which the word "building" included. Further it extends the law to include an "attempt to break and enter" and provides penalties therefor.[7]

Checks—Insufficient Funds. Senate Bill 306 redefines this offense. It includes the issuance or delivery of such a check with intent to defraud and deceive, (1) to obtain something of value or (2) to pay for goods, rents or services. It provides increasing penalties for subsequent violations.

Checks—No Account. The issuance or delivery of a check on no account or no funds in payment for goods, rents or services with the intent to defraud is declared to be a felony.[8]

DAMAGES

Wrongful Death. Maximum recoverable damages are $25,000. This applies only to actions accruing after the effective date of the law.[9]

EVIDENCE

Blood Grouping Tests in Paternity Cases. House Bill 133 authorizes the court to order a blood grouping test on motion of the defendant. Results of the test are admissable only if they exclude the defendant as the father.

Business and Public Records as Evidence. Senate Bill 275 permits copies of bank or trust company trust department records to be introduced in evidence under the uniform photographic records act.

EXTRADITION

Senate Bill 249 extends the provisions of the extradition laws to include probation and parole violators and empowers the parole board to apply for the issuance of requisitions for the return of such persons from other states.

GAME AND FISH

Penalties Assessed for Certain Violations. Senate Bill 185 lists

[6] Colo. Rev. Stat. Ann. §§ 39-16-1 to 11 and §§ 39-19-1 to 9 (1953).
[7] House Bill 173.
[8] Senate Bill 304.
[9] House Bill 111. See Hall, *Damages for Death—Limited or Unlimited*, 34 DICTA 32 (1957); Note, 34 DICTA 41 (1957).

certain specific game and fish violations and sets a fine for each. Moreover it authorizes officers to serve violators penalty assessment tickets which operate as summonses if not paid. In case of prosecution for the specific violation, the maximum penalties apply.

INCOME TAX

The "Golden Gimmick." House Bill 232 provides that beginning April 15, 1958, income taxpayers will no longer have the option of paying their preceding year's income tax in quarterly installments. The entire 1957 tax will be due on April 15, 1958, and any subsequent years' taxes will be due in full on the 15th day of April following the end of that year.

Exemptions and Reductions. House Bill 49 decreases the reduction in income tax from 20% to 15%, increases the personal exemption to $750, and excludes (1) labor union pensions, (2) federal civil service annuities, and (3) OASI payments from taxable income.

INDUSTRIAL COMMISSION

Appointment of Counsel for Indigent Petitioners. Fees are fixed by the commission and paid from the compensation awarded. If the award is denied, the commission pays the fee.[10]

INHERITANCE TAX

Credits. House Bill 72 rewrites the present law to provide a workable formula for determining the inheritance tax credit for property which, within three years previously, has been taxed in the estate of a decedent. It provides a ratio, or fraction, which is the relationship of the traceable taxed property in the prior estate to the total property therein. The same ratio, or fraction is determined in the current estate. This fraction is applied to the tax due in the current estate. If the resultant tax in the prior estate is greater than the resultant tax in the current estate, a tax credit equal to the resultant tax in the current estate is allowed. If the resultant tax in the prior estate is less than the resultant tax in the current estate, the credit is equal to the resultant tax in the prior estate.

LABOR

Increased Benefits. Increases have been provided in workmen's compensation benefits,[11] occupational disease benefits,[12] and unemployment compensation benefits.[13]

MENTALLY ILL

Adjudication and Commitment. Senate Bill 161 extends the jurisdiction of county courts to cover all persons in their counties alleged to be mentally ill and introduces such temporary emergency procedures as "protective arrests" and "short-term involuntary hospitalization" not to exceed six months. The changes are effective July 1, 1957.

Estates of Mentally Ill Persons and Minors. Senate Bill 162 rewrites the provisions governing the appointment of personal rep-

[10] Senate Bill 102.
[11] Senate Bill 289.
[12] Senate Bill 291.
[13] Senate iBill 290.

resentatives for nonresident minors and for resident and nonresident mentally ill persons. Also it provides a method of sealing and inventorying a mentally ill person's safety deposit box under supervision of the county court and provides a voluntary adjudication procedure on petition of a mentally ill person to the county court.

MOTOR VEHICLES

Non-resident Motorists—Agent for Service. Senate Bill 43 provides that the operation in this state of a motor vehicle, within the scope of his employment, by the agent, servant or employee of a nonresident designates the Secretary of State such nonresident's agent for service of process.

Restricted Operators' Licenses. House Bill 375 permits the issuance of restricted licenses to operate motor vehicles to certain mentally ill persons upon proper certification of the lunacy commission, approved by the court.

Release of Security Deposits. Senate Bill 362 makes it the duty of persons who have deposited security in accordance with the Safety Responsibility Law to notify the Director of Revenue of the status of the claim before the expiration of one year from the date of deposit. Security deposits of depositors who cannot be located will escheat to the state after thirty days' notice by registered mail sent to the address of record.

OIL AND GAS LEASES

House Bill 384 requires the lessee under an oil and gas, or other mineral, lease to record an acknowledged release thereof in the county where the land is situated within ninety days after forfeiture or expiration of the lease. On his failure to do so, the landowner may sue and recover $100 in damages plus costs.

PAROLE AND PROBATION

Violators. Senate Bill 347 adds a new amendment to the present interstate compact whereby the parole or probation violator may be incarcerated in the state where he is found rather than being returned to the original state of incarceration. Furthermore, Senate Bill 348 authorizes the Executive Director of the State Department of Parole to deputize any regular employee of Colorado or any other state, thus giving that employee the powers of a police official to return parole and probation violators.

PLANNING AND ZONING

Plats of County Land. Senate Bill 154 requires that subdivision plats and plats of public works pertaining to lands within three miles of any municipality be submitted to such municipality for its recommendations, or for a period of thirty days, before further action can be taken thereon.

PRISONERS

Right to Consult Counsel. House Bill 21 subjects peace officers to penalties for failure to allow a prisoner to see and consult counsel upon the request of a friend, relative or spouse of the prisoner, if the prisoner expressly consents to see such counsel. Heretofore, the penalties applied only when the prisoner was denied counsel on his own request.

RESTRAINT OF TRADE

Senate Bill 200 declares monopolies, combinations and contracts which fix the price or quantity of an article in commerce to be in restraint of trade and illegal. Contracts with innocent persons which are related to or grow out of any violation are void. The statute provides for injunctive procedure and criminal penalties.

WATER

Adjudication Decrees—Eighteen-Year Limitation. Senate Bill 176 provides that a water priority decree shall not be set aside after eighteen years for any defect in the adjudication proceedings, if for such period it has been recognized by water officials and the water thereof has been applied to beneficial use whenever needed.

Alternate Diversion Point—Cities and Towns. Senate Bill 326 authorizes municipalities to maintain one alternate diversion point, provided such right is evidenced by court decree.

Conservancy Districts. House Bill 289 provides a method for dissolving them.

Underground Water. Senate Bill 113 provides for an eight-member "Ground Water Commission" to be appointed by the Governor and confirmed by the Senate. The Commission is to be assisted by the water conservation board and the state engineer. Upon completion of a survey of the state's general ground water resources, it may designate portions thereof as "tentatively critical ground water districts," in which the drilling or enlarging of wells is restricetd. In such districts the commission will conduct the election of a district advisory board. The board, by unanimous vote can remove the restriction. It requires filings with the state engineer on all new wells and on all existing wells and gives the state engineer authority to control well drillers. Exempted from the act are all wells used solely for stock watering, artesian wells with discharge pipes of diameters less than three inches, and domestic wells with discharge pipes of two inches diameter or less.

WILLS

Depositions. In cases where a deposition is taken to prove the execution of a will in a proceeding to admit it to probate, a new statute will permit a photographic copy certified by the judge, instead of the will itself, to be attached to the dedimus.[14]

Disclaimer. House Bill 365 provides a method whereby a person entitled to a legacy, devise or bequest under a will may disclaim it, and the bill states the effects of a disclaimer.

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[14] House Bill 258.

THE FATE OF THE COURT BILLS IN THE FORTY-FIRST GENERAL ASSEMBLY

BY PETER H. HOLME, JR.

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Legislation affecting judges and courts is, of course, of deep interest to the bench but of almost equal interest to the bar. Consequently, this *post mortem* is tendered so that the lawyers of the state may be aware of what happened to the various bills which were proposed in the 41st General Assembly which would have changed and in most cases improved Colorado's judicial system.

THE JUDICIAL SELECTION PLAN

Senate Concurrent Resolution No. 2 embodied the long sought reform in our method of selecting judges for our major courts. This bill to remove the selection of judges from the political arena obviously had to be in the form of a constitutional amendment. In S.C.R. No. 2, the legislature was being asked to place the proposed constitutional amendment upon the ballot in 1958. Several hearings were held before the judiciary committees of the House and Senate, at which time was generously alloted to both proponents and opponents to express their views. Much serious consideration was devoted to this concurrent resolution with the result that many legislators, formerly either neutral or indeed vigorously opposed to its subject matter, became interested and in many cases indicated a change of position in favor of the proposal. Owing to a policy proposed by the Governor and adopted by the Assembly, however, no final action was taken placing any constitutional amendment on the ballot. It was agreed that an interim committee consisting of the judiciary committees of the House and Senate would be formed to consider, between now and the 1958 session of the General Assembly, all constitutional amendment proposals. In line with this policy, Senate Concurrent Resolution No. 2 was referred to this committee on constitutional amendments. During the ensuing months additional opportunity will be presented for further discussion of the judicial selection plan amendment.

JUDGES' COMPENSATION BILLS

Quite a number of bills were presented which would have increased the compensation of judges of the various courts. For supreme court judges there were House Bills No. 5 and No. 38; for district court, House Bill No. 3; for the county and juvenile courts, House Bills 25, 303 and 408, relating to certain counties only, and Senate Bill 115, relating to the Denver courts; and for the superior court, House Bill 50. There was also a bill for compensation of courts of record generally,[1] and a bill to adjust the compensation of justices of the peace.[2]

In addition to the direct salary bills, there was a bill which would have increased the expense allowances for judges[3] and one which would have furnished additional expense money for judges while on duty outside their home counties.[4]

Without exception all of these bills failed of passage.

The only bill passed which had to do with financial assistance to the courts was the retirement bill.[5]

QUALIFICATIONS OF JUDGES

Another bill affecting courts which did pass and was signed by the Governor is House Bill 57 which provides that henceforth with the exception of incumbent judges, any new candidate for the office of County Judge in counties of the first or second class must, as a pre-requisite qualification, be a lawyer.

JURISDICTIONAL AND PROCEDURAL BILLS

A bill[6] relating to criminal proceedings before the justice courts and requiring the judge to render a decision within ten days has been passed and was signed by the Governor. Likewise, a bill[7] granting to the justice and police courts the power to suspend fines and grant stays of execution was passed and signed.

On the other hand the following bills failed: House Bill 11, involving appeals from police, municipal and justice courts; House Bills 381 and 259 relating to the jurisdiction of the superior court; and House Bill 269 relating to the superior court's power to grant probation. Also House Bill 308 relating to justices and constables failed of passage.

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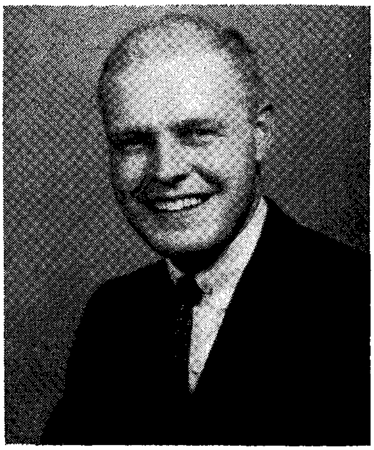
[1] House Bill 156.
[2] Senate Bill 212.
[3] House Bill 12.
[4] House Bill 146.
[5] Senate Bill 173.
[6] House Bill 46.
[7] House Bill 182.

NOTES

Dog's Bill of Rights

BY ROBERT B. YEGGE



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Actual records trace the mammal *Carnivora,* family *Canidae,* back to the Egyptian tomb of Amten of the Fourth Dynasty — about 3500 B.C. Since that time the service, devotion and heroism of the dog have earned him recognition as "Man's Best Friend," a title enjoyed by no other member of the animal kingdom. Despite this praiseworthy heredity, man seems to be questioning the underlying friendliness of the dog. In the last century, dogs have been the object of increasing claim compensation. This new source of lawsuits is significant since there are an estimated 13,000,000 dogs in the United States — one dog for every ten persons.

In early legal history, the dog was protected by being allowed "one free bite." But courts have discarded that principle[1] for a new legal fiction of liability — a fiction spuriously called "vicious propensities." While the vicious propensity test appears universal in the legal literature, its application is variously handled.

Some jurisdictions using the vicious propensity test determine dog bite liability in terms of nuisance. While a dog is not a nuisance **per se**,[2] the courts which apply the nuisance theory investigate the disposition and conduct of the dog and the manner in which he has been kept in determining the nuisance question. Following this theory, it has been said that, "a person who keeps a dog which is dangerous to mankind with knowledge of its vicious propensities is liable on the theory of nuisance for injuries resulting therefrom to others, irrespective of the question of negligence on his part."[3]

Another line of authority establishes liability in terms of negligence. In these cases it is necessary for the plaintiff to establish the dog's vicious propensities in order to show negligence or fault on the part of the owner. The negligence or fault is established

[1] See, e. g., Andrews v. Smith, 324 Pa. 455, 188 Atl. 146 (1936).
[2] Smith v. Costello, 77 Idaho 205, 290 P.2d 742 (1955).
[3] Annot., 79 A.L.R. 1060, 1062 (1932).

upon showing that the owner did not take steps which would prevent injury or damage after he became aware of the dog's vicious nature.[4]

A third theory of dog bite liability is that which Colorado has recognized. It appears that the Colorado Supreme Court imposes strict liability on a dog owner who has prior knowledge of his dog's vicious propensities. In *Barger v. Jimerson*,[5] the court said, "It is quite evident that defendants did not at any time carelessly or intentionally allow the dog to run at large. Their liability was in keeping such a dog and they did so at their peril."[6]

Another form of strict liability is found in the statutes of Connecticut and Massachusetts. These identical statutes impose strict liability on the keeper of a dog for any damage which the dog does unless the damage was a result of trespass (or other tort), or of teasing, tormenting or abusing the dog.[7] Florida,[8] Iowa,[9] New Hampshire,[10] Ohio[11] and Rhode Island[12] have statutory provisions which are similar in wording and in effect.

Unless otherwise provided by statute, a necessary element of proof for establishing dog bite liability is proof of the vicious propensity of the dog. The test for vicious propensity appears to be universal. The plaintiff must show: (1) that the dog had exhibited certain tendences, (2) that the tendencies were of the nature to put prudent persons on guard against possible injury, and (3) that the tendencies were known to the owner prior to the injury for which redress is sought.[13]

The element of vicious propensity being essential in an action for dog bite regardless of the theory upon which liability is based, it is obvious that, unless otherwise provided by statute, simple proof of a dog bite and damage therefrom does not make out a *prima facie* case for the plantiff. It is in the area of proof of vicious propensity that many dog bite claimants fail. The authorities have set forth some important guide posts for such proof.

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[4] Woulfe v. D'Antoni, 158 So. 394 (La. App. 1935).
[5] Barger v. Jimerson, 130 Colo. 459, 276 P.2d 744 (1954).
[6] *Id.* at 462, 276 P.2d at 745.
[7] Conn. Gen. Stat. c. 151a, § 1842d (Supp. 1955); Mass. Ann.. Laws, c. 140, § 155 (1949).
[8] Fla. Stat. § 767.04 (1953).
[9] Iowa Code § 351.28 (1946).
[10] N. H. Rev. Stat. Ann. § 466.19 (1955).
[11] Ohio Rev. Code Ann. § 955.28 (1953).
[12] R. I. Gen. Laws Ann. c. 639, § 3 (1938).
[13] See note 5 *supra.*

What types of prior tendencies amount to vicious propensities? Following the rationale of the early "one free bite" principle, a prior attack on a human has been held sufficient to prove vicious propensities.[14] Evidence that a trained watchdog snarled and showed his teeth when petted by guests at the dog owner's hotel was also considered sufficient proof.[15] The ferocious and violent nature of a dog as evidenced by his barking, running to and lunging upon a fence when humans came near the fence has been held, by the Colorado Supreme Court, to be adequate proof of vicious propensities.[16] However, the Pennsylvania court has said that the mere fact that the person bitten was afraid of the dog prior to the bite does not prove the dog was vicious.[17]

What constitutes adequate owner knowledge of vicious propensities? The United States Court of Appeals for the Third Circuit has held that keeping and training a dog as a watchdog warrants the inference that the owner has knowledge of the dog's vicious propensities.[18] However, the Pennsylvania court has held that the mere keeping of a German shepherd to protect property against intruders is not sufficient to show that vicious propensities were known to the owner.[19] Constant owner admissions that the dog was "bad," made after the injury but prior to the trial, were held to constitute proof that the admitting owner had knowledge of the dog's vicious propensities.[20] The Colorado court has held that a dog owner had knowledge of his dog's viciousness upon a showing that he kept the animal confined because it was inclined to jump at approaching humans.[21] Furthermore, the owner must have had personal knowledge of the vicious propensities. Thus it has been held that the knowledge of a neighbor or of the owner's yardman is not imputed to the owner.[22] However, the knowledge of a servant who has control of the dog may be imputed.[23] In Colorado, an owner who knows or should know that his animal has been exposed to rabies is charged with that knowledge and is liable for the consequences of an injury inflicted while his dog is rabid.[24]

One might conclude, without consulting the authorities, that a trespasser has no cause of action for dog bite. However, this position is not supported by the courts. The New Jersey Supreme Court has held that, as a matter of law, the mere fact that the injured person was a trespasser at the time of an attack by a "vicious" animal does not defeat his action.[25] The theory supporting this decision was aptly stated in a leading case involving trespassing persons who are injured by animals found to have vicious propensities. Thus in *Marble v. Ross*,[26] the Massachusetts court reasoned

[14] See, e. g., Peyronnin v. Riley, 15 La. App. 393, 132 So. 235 (1931).
[15] Zarek v. Fredericks, 138 F.2d 689 (3d Cir. 1943).
[16] See note 5 *supra*.
[17] Fink v. Miller, 330 Pa. 193, 198 Atl. 666 (1938).
[18] See note 15 *supra*.
[19] Andrews v. Smith, 324 Pa. 455, 188 Atl. 146 (1936).
[20] Moore v. Smith, 6 So. 2d 803 (La. App. 1942).
[21] See note 5 *supra*.
[22] See note 4 *supra*.
[23] Bonko v. Stepp, 199 Okla. 119, 184 P.2d 615 (1947); *accord*, Young v. Estep, 178 Wash. 561, 35 P.2d 80 (1934) (chimpanzee).
[24] Carlberg v. Willmott, 87 Colo. 374, 287 Pac. 863 (1930).
[25] Eberling v. Mutillod, 90 N. J. L. 478, 101 Atl. 519 (1917).
[26] Marble v. Ross, 124 Mass. 44 (1878).

that if a trespasser is injured by an animal which has vicious propensities known to the owner, the owner vicariously inflicts injury on the trespasser in a wanton manner. The court supported its position by citing the time-honored principle that a landowner may not inflict a wilful and wanton injury on a trespasser—a position analagous to the spring gun cases so frequently found in texts.

Children are particularly protected aginst the defense of trespass. In a 1934 Pennsylvania case,[27] an owner who kept a dog with known vicious propensities was held liable to an injured three year old, notwithstanding the defendant's allegation of trespass. A Louisiana court imposed liability on an owner of a known vicious dog without considering the owner's allegation that the twelve year old victim was a trespasser.[26]

In spite of the principle that trespassers are protected against vicious dogs, it does not follow that trained watchdogs are legal booby-traps. The determining question in an action by a trespasser injured by a trained watchdog is the care with which the watchdog owner has kept his dog. The New York appellate division has held that a dog known to be vicious can be kept to protect one's property provided the owner uses caution to confine the dog so that it may move only in the area where premises are to be protected.[29] The owner who meets the standard of caution calculated to avoid wilful injury to the innocent trespasser need not give the trespasser notice of the dog's vicious propensity.[30]

An interesting sidelight on dog bite liability is presented in cases where business invitees are bitten by dogs. Apparently, invitee status does not alter the vicious propensity test nor does it alter the application of the test. In *Zarek v. Fredericks*,[31] a federal court of appeals established that the plaintiff was a business invitee and then stated, "The question, so far as it concerns liability, is limited to the sufficiency of proof that the dog was vicious and the defendant knew or had reason to know that fact."[32] Similarly, in *Splaine v. Eastern Dog Club, Inc.*,[33] the Supreme Judicial Court of Massachusetts granted "business visitor" status to the plaintiff and added that the defendant dog club owed the plaintiff a duty to use reasonable care to keep the plaintiff, a dog exhibitor, free of harm from other dogs at the dog show. However the court concluded that, notwithstanding this duty, there was no proof of the offending dog's vicious propensity prior to its biting the plaintiff and therefore the defendant was not liable.

Common law liability for dog bite continues in most jurisdictions, with the qualifications above mentioned, unless changed by statute or replaced by new legal fictions. If there is any significant trend discernable, it is the extending of the definition of vicious propensity to include less offensive kinds of canine conduct.

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[27] Darbly v. Clare Food and Relish Co., 111 Pa. Super. 537, 170 Atl. 387 (1934).
[28] See note 20 *supra*.
[29] Woodbridge v. Marks, 17 App. Div. 139, 45 N. Y. Supp. 156 (3d Dep't 1897).
[30] *Ibid.*
[31] 138 F.2d 689 (3d Cir. 1943).
[32] *Id.* at 690.
[33] 306 Mass. 381, 28 N. E. 2d 450 (1940).

CASE COMMENTS

Constitutional Law—Equal Protection in Class Legislation— Colorado Sunday Closing Statute Upheld

By Thomas A. Nelson, Jr.

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Plaintiffs, automobile dealers, were precluded by a Colorado statute[1] from selling automobiles on Sundays. Other businesses, including filling stations, motor repair shops, auto accessory businesses and farm machinery dealers were allowed to operate on Sundays. Plaintiffs sought a declaratory judgment that the statute violated both the Colorado constitution's prohibition of "special laws"[2] and the equal protection clause of the Federal Constitution's fourteenth amendment.[3] The Colorado Supreme Court initially held the act unconstitutional[4] but on rehearing declared it constitutional. *Mosko v. Dunbar,* 309 P.2d 581 (Colo. 1957).

Since judicial construction has given the federal equal protection clause the same meaning as the Colorado constitution's "special laws" provision, consideration of one is necessarily consideration of both. The Supreme Court of Colorado has considered the issue of the constitutionality of Sunday closing laws several times before. The previous cases, like the instant case, concerned legislation directed at particular segments of the business community rather than all-inclusive Sunday closing laws. In *Denver v. Bach,*[5] an 1899 case, the supreme court held an ordinance which prohibited the sale of clothing on Sunday to be unconstitutional as class legislation prohibited by the Colorado constitution. A similar question arose several years later in *McClelland v. Denver,*[6] dealing with an ordinance which forbade barbering on Sundays. The high court in this instance declared the ordinance constitutional. Two years later *Mergren v. Denver*[7] questioned the constitutionality of an ordinance precluding Sunday operation of meat markets and grocery stores. The supreme court, following the Bach case, found this ordinance to be class legislation forbidden by the state constitution.[8] Then, in a 1938 case,[9] the Colorado court ruled on a Denver ordinance which prohibited the sale of new and used automobiles on Sundays. The ordinance was upheld against a contention that it was discriminatory special or class legislation. It should be noted that the ordinance upheld in 1938 was substantially identical to the statute involved in the *Mosko* case.

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[1] Colo. Rev. Stat. Ann. § 13-20-1 to 3 (Supp. 1955).
[2] Colo. Const. art. 5, § 25 (1876).
[3] U. S. Const. amend. XIV, § 1.
[4] 8 Colo. Bar Ass'n Adv. Sh. 16 (1956).
[5] 26 Colo. 530, 58 Pac. 1089 (1899).
[6] 36 Colo. 486, 86 Pac. 126 (1906).
[7] 46 Colo. 385, 104 Pac. 395 (1909).
[8] *Accord:* Allen v. Colorado Springs, 101 Colo. 498, 75 P.2d 141 (1937) (invalidated similar ordinance of Colorado Springs).
[9] Rosenbaum v. Denver, 102 Colo. 530, 81 P.2d 760 (1938).

The opinion in the instant case declared that the new and used automobile business is a business separate and distinct from any other business, and that the statute treats equally all within the business. Thus the court found that the act afforded all auto dealers the equal protection of the laws. In so holding, the Colorado court adopted from its previous decisions the criterion that where the legislature enacts a Sunday closing law applicable to a legitimate occupation or business, it will be upheld if there is any reasonable basis for distinguishing businesses affected from businesses allowed to remain open. The court relied heavily on its finding that the sale, ownership and use of automobiles have been the subjects of numerous legislative enactments which have treated automobile law as a separate and distinct category. In support of this finding the court cited *Gundaker Motors v. Gassert*,[10] a late 1956 New Jersey case upholding a statute which outlawed the sale of automobiles on Sundays, but allowed other businesses to remain open. In an opinion by Chief Justice Vanderbilt, the New Jersey court had held that the automobile business constitutes a "class" differing from any other class, and since the statute treated persons within that class fairly and impartially, it did not violate the fourteenth amendment. The courts of Nebraska[11] and Illinois[12] have upheld Sunday closing laws for auto dealers. On the other hand, the Florida court invalidated a general Sunday law which expressly exempted newspapers, theatres, filling stations, restaurants, grocery and drug stores, hotels, parking lots and transportation companies, but not auto dealers and garages.[13] That classification was considered arbitrary.

Those opposed to classification like that in the principal case have objected that although the business regulated may differ factually from other businesses, mere factual difference should not be the determinant. They argue that, in order to be held constitutional, a classification must not only be reasonable and not arbitrary, but must rest upon a difference having a fair and substantial relation to the *object of the legislation.* This test was laid down by the United States Supreme Court in *Old Dearborn Distributing Co. v. Seagram Distillers Corp.*[14] In other words, the fact that all within a business or occupation are included within the terms of an act should not be enough to validate the act. The validity of classification should be determined by considering the objective of the legislation. For example, if the objective is to limit the number of hours worked, the classification should be broad enough to bring within

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[10] 127 A.2d 566 (N. J. 1956).
[11] Stewart Motor Co. v. Omaha, 120 Neb. 776, 235 N. W. 332 (1931).
[12] Humphrey Chevrolet Co. v. City of Evanston, 7 Ill. Bluebook 2d 402, 131 N. E.2d 70 (1955).
[13] Henderson v. Antonacci, 62 So.2d 5 (Fla. 1952).
[14] 299 U. S. 183 (1936).

it every business and avocation in order to prevent any person or business from exceeding the limitations. If the object is to protect Sunday as a day of rest, the statute should preclude all from working on Sundays. Of course, in those jurisdictions which have enacted all-inclusive Sunday laws, certain works of necessity and charity have been exempted for practical reasons.[15]

Unfortunately neither the state nor the federal courts have followed the rationale of the *Old Dearborn* case. It is apparent from the cases previously mentioned that the Colorado court has not applied this principle,[16] but instead has rested its decisions on whether a classification has brought within the operation of the law those whose businesses were reasonably distinguishable from the businesses of other outside the statute, and whether it has forbidden all competitors to remain open. However, a well written dissent in the instant case indicated that Mr. Justice Sutton may have recognized the distinction in rationales.[17]

Mr. Justice Holmes, in *Patersone v. Pennsylvania*,[18] declared,

> "(A) state may classify with reference to the evil to be prevented, and . . . if the class discriminated against is or reasonably might be considered to define those from whom the evil mainly is to be feared, it properly is picked out. A lack of abstract symmetry does not matter. The question is a practical one, dependent upon experience. . . . It is not enough to invalidate the law that others may do the same thing and go unpunished, if, as a matter of fact, it is found that the danger is characteristic of the class named."[19]

Mr. Justice Holmes' statement could be paraphrased to express the reasoning of the Colorado court in the *Mosko* case, dealing with the dangers which experience has shown to be particularly peculiar to the automobile selling business so as to "mark the class." The

[15] See, e. g., Ross v. State, 9 Ind. App. 35, 36 N. E. 167 (1894).
[16] See also, Smith Brooks Printing Co. v. Young, 103 Colo. 199, 35 P.2d 39 (1938); Rifle Potato Growers v. Smith, 78 Colo. 171, 240 Pac. 937 (1925); Consumer's League v. Southern R. R. Co., 53 Colo. 54, 125 Pac. 577 (1912).
[17] 309 P.2d at 597.
[18] 232 U. S. 138 (1913).
[19] *Id* at 144. Cf. West Coast Hotel Co. v. Parrish, 300 U. S. 379 (1937); Bayside Fish Flour Co. v. Gentry, 299 U. S. 422 (1936); People v. Zimmerman, 278 U. S. 63 (1928).

United States Supreme Court has stated, in other cases, that a law which hits the evil where it is most felt is not to be overthrown because there are other instances to which it might have applied.[20] That Court has not passed upon the validity of Sunday closing laws regulating automobile dealers. However, it upheld a Minnesota statute which prohibited barbering on Sundays[21] and it appears from prior decisions that the Court will uphold the kind of classification inherent in auto dealer Sunday closing laws.

Related to the question whether Sunday closing laws are discriminatory class legislation, is the question whether legislature enacting such laws are within their police power. Chief Justice Moore raised this question in a dissent in the principal case.[22] In any case which involves class legislation, a consideration of whether the legislature enacted the questioned statute in the interest of the public health, welfare, safety and morals, is necessary. A law making body has no power under the guise of police regulation to arbitrarily invade the personal rights and liberties of an individual citizen.[23] The Colorado Supreme Court, in the cases considered, either expressly or impliedly held the enactment of Sunday closing laws to be within the police power. That all-inclusive Sunday laws are within the police power seems unquestionable, and, assuming this, the argument that particular Sunday closing laws are void because of exceeding the police power is merely begging the question of class legislation.

It is interesting to note that the Supreme Court of the United States in 1834 declared it to be the practice of that Court not to hold statutes unconstitutional by a bare majority.[24] Ohio,[25] Nebraska[26] and North Dakota[27] have constitutional provisions to the effect that statutes cannot be declared unconstitutional by a bare majoriy decision. The reasoning behind these provisions is particularly interesting in regard to the instant case, in light of the initial holding by a four to three decision that the statute was unconstitutional, and the final holding, again four to three, that it was constitutional.

In Colorado as elsewhere a statute must be plainly, palpably and beyond a reasonable doubt unconstitutional before a court may invalidate it.[28] Can a statute which three out of seven judges consider valid, be plainly, palpably and beyond a reasonable doubt unconstitutional?

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[20] Pearson v. Probate Court, 308 U. S. 518 (1939); Silver v. Silver, 280 U. S. 117 (1929).
[21] Petit v. Minnesota, 177 U. S. 164 (1899).
[22] 309 P.2d at 593.
[23] Chenoweth v. State Board, 57 Colo. 574, 141 Pac. 132 (1913).
[24] City of New York v. Miln, 11 U. S. (8 Pet.) 43 (1834).
[25] Ohio Const. art. 4, § 2 (1912).
[26] Neb. Const. art. 5, § 2 (1875).
[27] N. D. Const. art. 4, § 89 (1918).
[28] Eachus v. People, 124 Colo. 454, 238 P.2d 885 (1951); McClain v. People, 111 Colo. 271, 141 P.2d 685 (1943); People ex rel v. Barksdale, 104 Colo. 1, 87 P.2d 755 (1939); People ex rel v. Letford, 102 Colo. 284, 76 P.2d 274 (1938).

REAL PROPERTY – RELATIVE PRIORITY OF LIENS – FEDERAL TAX LIEN PRIORITY: A JUDICIAL FRANKENSTEIN

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In the recent case of *United States v. Vorreiter,*[1] the Colorado Supreme Court added its voice to the growing chorus of state[2] and federal[3] court dissatisfaction with the United States Supreme Court's absolutism in according federal tax liens priority over all types of state liens.[4]

In the *Vorreiter* case, one Price, a resident of Texas, contracted with Vorreiter, a Colorado resident, for the improvement of Price's Colorado realty. Prior to the making of this contract, the Collector of Internal Revenue in Austin, Texas, received assessment lists for taxes owed by Price to the United States. The Internal Revenue Code has long accorded the United States a general lien for unpaid taxes.[5] Under the 1939 code, which governed, the tax lien arose at the time the Collector received the assessment list[6] and attached to all property of the taxpayer,[7] but was invalid against "any mortgagee, pledgee, purchaser, or judgment creditor"[8] unless recorded in the office designated by state law. In the instant case, notice of the federal lien was not filed in Colorado until after Vorreiter had completed work under his contract and had filed a mechanics' lien notice against Price's property. The Colorado statute[9] grants the mechanics' lien superiority over all prior and subsequent unrecorded liens of which the mechanic's lien claimant has no notice.

In an action to foreclose the mechanics' lien, the Colorado Supreme Court found the subsequently arising but prior recorded mechanics' lien superior to the federal tax lien. The court reasoned: (1) To give the federal tax lien priority would be to negate a settled rule of Colorado property law, (2) The federal tax lien attaches only to property owned by the taxpayer at the time the lien arises. (3) To allow the Government to appropriate the inhanced value of

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[1] 307 P.2d 475 (Colo. 1957).

[2] *E.g.,* United States v. Colotta, 79 So.2d 474 (Miss.), *rev'd per curiam,* 350 U. S. 808 (1955).

[3] *E. g.,* United States v. White Bear Brewing Co., 227 F.2d 359 (7th Cir. 1955), *rev'd per curiam,* 350 U. S. 1010 (1956).

[4] For excellent treatments of this whole problem, see Reeve, *The Relative Priority of Government and Private Liens,* 29 Rocky Mtn. L. Rev. 167 (1957); Kennedy, *The Relative Priority of the Federal Government: The pernicious Career of the Inchoate and General Lien,* 63 Yale L. J. 905 (1954).

[5] The Internal Revenue Code of 1939, which governed the *Vorreiter* case, provided:

> "§ 3670. Property subject to lien. If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount . . . shall be a lien in favor of the United States upon all property and rights thereto, whether real or personal, belonging to such person." Cf. Int. Rev. Code of 1954, § 6321.

[6] "§ 3671. Period of lien. ". . . (T)he lien shall arise at the time the assessment list was received by the collector and shall continue until the liability for such amount is satisfied or becomes unenforceable by reason of lapse of time." Cf. Int. Rev. Code of 1954, § 6322.

[7] See note 6 *supra.*

[8] "§ 3672. Validity against mortgagees, pledgees, purchasers and judgment creditors. (a) *Invalidity of lien without notice.* Such lien shall not be valid against any mortgagee, pledgee, purchaser or judgment creditor until notice has been filed by the collector. . . ."

[9] Colo. Rev. Stat. Ann. § 86-3-6 (1953).

the taxpayers' property would be to confiscate the work and materials of the mechanics' lienor to pay the taxes of another, contrary to the doctrine of unjust enrichment. (4) Chief Justice Moore, specially concurring, asserted that the federal statutory exception protecting mortgagees, pledgees, purchasers and judgment creditors without notice, should be broadened by interpretation to include mechanics' lienors.[10]

The result in the principal case directly contravenes the construction the United States Supreme Court has given the tax lien created by section 3670 of the 1939 code. As a review of its reasoning will demonstrate, the Colorado court pointedly omitted mention of this long standing construction and the cases in which the United States Supreme Court established it.

(1) *Settled Rule of Property.* The cases cited by the Colorado court to support its contention that the United States Supreme Court will defer to state decisions which establish a settled rule of property within that state, are clearly inapplicable.[11] Indeed, *United States v. Snyder,*[12] the first Supreme Court decision to construe the predecessor of section 3670,[13] manifested no hesitation in invalidating a Louisiana recording statute which would have defeated the federal lien as an unrecorded lien.[14] Moreover, the Constitution's recitation of the federal power to tax,[15] when considered with the supremacy clause,[16] seems decisive.

(2) *Property Affected by the Tax Lien.* The Colorado court's theory that the federal lien attaches only to property owned by the taxpayer when the lien arises is inconsistent with the *Glass City Bank case.*[17] There the United States Supreme Court held that the federal tax lien applies to any property owned by a taxpayer at any time during the life of the lien, although acquired after the lien arises.

(3) *Unjust Enrichment—Payment of Another's Taxes.* The Colorado court's contention that awarding the federal tax lien priority would unjustly enrich the United States, and, in effect, require the mechanics' lienor to pay another's taxes, has great merit. The Supreme Court, however, has consistently ignored this argument. In point is the above mentioned *Snyder* case which involved a tobacco tax lien upon land. After the tax lien arose, the land was conveyed to a good faith purchaser who had no notice of the lien. When *Snyder* arose, the federal lien statute contained no provision invalidating an unrecorded tax lien against "purchasers."[18] The question presented was whether the federal lien could be defeated by a state recording statute. The answer, of course, was negative, and the tax lien was foreclosed against the good faith purchaser.

[10] 307 P.2d at 479.

[11] The Colorado court cited Edward Hines Yellow Pine Trustees v. Martin, 268 U. S. 458 (1925); Warburton v. White, 176 U. S. 484 (1899) and Burcher v. Cheshire R. Co., 125 U. S 555 (1888), none of which concerned matters of taxation or lien priorities.

[12] 149 U. S. 210 (1893).

[13] Rev. Stat. § 3186 (1878), *as amended,* 20 Stat. 327, 331 (1879).

[14] La. Const. art. 176 (1879).

[15] U. S. Const. art. I, § 8, subs. 1; U. S. Const. amend. XVI.

[16] U. S. Const. art. VI, § 2.

[17] Glass City Bank v. United States, 326 U. S. 265 (1945).

[18] 20 Stat. 327, 331 (1879), *amended,* 37 Stat. 1016 (1913), (lien made invalid without notice against mortgagees, purchasers or judgment creditors), *amended,* 45 Stat. 875 (1928) (added pledgees to those protected from unrecorded lien).

Following this severe precedent, the Supreme Court has frequently applied the theory that the federal tax lien statute creates a secret, general lien[19] valid, without regard to notice, against all subsequent lienors who cannot bring themselves within the enumerated exceptions.[20] Moreover, where it has appeared that a state lien was first in time to the federal tax lien, the Court has gone to great lengths to find an "imperfection" in the state lien sufficient to defeat its priority.[21] Although in the *Vorreiter* case, the Colorado mechanics' lien did not even enjoy the dubious distinction of being first in time, the cases establishing the doctrine of "perfection" illustrate the Court's historic indifference to these arguments advanced by the Colorado court in favor of Vorreiter's lien.

(4) *Lienor as Mortgagee, Pledgee, Purchaser and Judgment Creditor.* Although the terms "mortgagee" and "pledgee" are obviously inapplicable, various attempts have been made to fit state lienors into the categories of "purchaser" and "judgment creditor." Nevertheless, by Supreme Court definition, a purchaser is one who acquires title or possession, in the manner of vendor and vendee, for a valuable consideration,[22] while a judgment creditor is one who has received a judgment from a court of record.[23]

The *Vorreiter* case represents a state court's justifiable exasperation with the inequities inherent in the United States Supreme Court's unrealistic and severe interpretation of the federal tax lien law. To understand how the Supreme Court's interpretation has distorted the language of section 3670, it is necessary to consider another federal statute, section 3466 of the Revised Statutes.[24] Section 3466 grants the United States first priority for debts due it from an insolvent. The priority attaches when the debtor's property passes to a third person (other than a trustee in bankruptcy) for distribution to creditors. Section 3466 creates no lien. It merely bestows a priority to inusre that any debts due the United States will first be satisfied.[25]

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[19] Mr. Justice Jackson's concurring opinion in United States v. Security Trust & Savings Bank. 340 U. S. 47, 51 (1950), traced the history of the § 3670 lien and approved the contention that it created a secret general lien.

[20] Mackenzie v. United States, 109 F.2d 540 (9th Cir. 1940).

[21] United States v. Liverpool & L.&G. Ins. Co., 348 U. S. 215 (1955) (garnishment lien superseded by a subsequently arising tax lien that was recorded before judgment); United States v. Acri. 348 U. S. 211 (1955) (state lien contingent upon outcome of wrongful death action); United States v. Gilbert Associates, Inc., 345 U. S. 361 (1953) (prior city tax lein); United States v. Security Trust & Savings Bank, 340 U. S. 47 (1950); New York v. Maclay, 288 U. S. 290 (1933) (prior unliquidated state franchise taxes).

[22] United States v. Scovil, 348 U. S. 218, 221 (1955); and see United States v. Kings County Iron Works, 224 F.2d 232 (2d Cir. 1955).

[23] United States v. Gilbert Associates, Inc., 345 U. S. 361 (1953).

[24] Rev. Stat. § 3466 (1875), 31 U. S. C. § 191 (1952).

[25] Massachusetts v. United States, 333 U. S. 611 (1948). The lower federal courts have held that neither § 3466 nor § § 3670-2 apply to proceedings in bankruptcy, reasoning that to so apply them would upset the scheme of distribution set out in the Bankruptcy Act. See United States v. Sampsell, 153 F.2d 731 (9th Cir. 1946), and cases cited there. Re Taylorcraft Aviation Corp., 168 F.2d 808 (6th Cir. 1948), appears to fall within this classification, but was cited by the Colorado court to support its unjust enrichment argument in *Vorreiter*. 307 P.2d at 478.

Early cases construing section 3466 apparently gave no credence to the theory that it created an absolute preference in favor of the United States to override antecedent liens.[26] However the twentieth century saw a growing tendency on the part of the Supreme Court to require that a state lien be "perfected" before it could compete with the federal priority for the funds of an insolvent.[27] The Court further implemented this growing doctrine by holding that the issue of perfection is, in the final analysis, a federal question.[28]

In *Illinois ex rel Gordon v. Campbell*[29] the Court reviewed and enumerated the elements which previous decisions had considered necessary to perfect a state lien. These were: (1) certainty of the identity of the lienor; (2) certainty as to the amount of the lien; (3) specific property attached by the lien, and (4) title to or possession of the affected property.[30] A lien deficient in any of these attributes when the federal priority arose was considered merely "a caveat of a more perfect lien to come."[31] Whether a sufficiently perfected state lien would in fact prevail over the federal priority is, as yet, merely conjectural. Because all the state liens yet to come before the Court have been found imperfct in some respect,[32] this important question has been reserved for later treatment.

The doctrinal armour of section 3466, with its almost unattainable standards, appears to have been transferred to the section 3670 tax lien in *United States v. Security Trust and Savings Bank.*[33] There a federal tax lien arose before a prior attaching creditor had pursued his lien to judgment. The Court held that since perfection of the creditor's lien was contingent on judgment, the federal lien must prevail.

However a ray of hope was extended to state lienors in *United States v. New Britain,*[34] where the Court found that certain city tax

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[26] Kennedy, note 4 *supra* at 907.
[27] Steps in this development were: Spokane County v. United States, 279 U. S. 80 (1929); New York v. Maclay, 288 U. S. 290 (1933); and United States v. Texas, 314 U. S. 480 (1941).
[28] United States v. Waddill, Holland & Flinn, Inc., 323 U. S. 353 (1945). But cf. Spokane County v. United States, 279 U. S. 80 (1929) (assumed the contrary).
[29] 329 U. S. 362, 375, 376 (1946).
[30] See United States v. Gilbert associates, Inc., 345 U. S. 361 (1953), where this last unique requirement of possession defeated a city's prior and otherwise specific liens for taxes.
[31] New York v. Maclay, 288 U. S. 290, 294 (1933).
[32] *E. g.*, United States v. Gilbert Associates, Inc., 345 U. S. 361 (1953).
[33] 340 U. S. 47 (1950).
[34] 347 U. S. 81 (1954).

and water rent liens sufficiently met the standards of identity, certainty of amount and specificity of the property attached to defeat a subsequently arising federal tax lien under the common law rule of "first in time is first in right." In this case, as in all others involving unforeclosed liens, the city had neither title nor possession of the property to which its lien had attached. The Court's disregard of what had been a fatal defect in cases concerning the section 3466 priority[35] suggested a difference in application of the doctrine to the section 3670 lien.[36]

Unfortunately, the bright ray extended by *New Britain* seems to have been extinguished by *United States v. White Bear Brewing Co.*,[37] where a mechanics' lien was recorded and in the process of enforcement before the federal lien arose, but the federal lien was recorded before judgmnt foreclosing the mechanics' lien was entered. The Supreme Court, without opinion, reversed the Seventh Circuit which had held for the mechanics' lienor. Since the *White Bear Brewing Co.* lien appeared to meet the *New Britain* requirements, the logical inference is to mark *New Britain* as a departure from, and *White Bear Brewing Co.* as a return to, application of the section 3466 doctrine of perfection to the section 3670 lien.[38]

The unsoundness of this result was pointed out by Judge Finnegan in his opinion for the Seventh Circuit in *White Bear Brewing Co.*[39] He noted that since the United States is a government of delegated powers, it enjoys no sovereign prerogative of priority of payment. In the absence of federal common law, whatever priority the United States claims must exist by virtue of statute.[40] To Judge Finnegan, the absence of a priority provision in section 3670 indicated Congress' intention not to render the federal tax lien absolute. He might have further observed that, although section 3670 refers simply to "a lien" for unpaid taxes, only a tortured reading can construe "a lien" to mean what the United States Supreme Court has attributed to the section 3670 tax lien.

If this judicial legislation is what the Colorado court protested in the *Vorreiter* case, its exasperation is reasonable. If, however, the Colorado court protested the secret floating lien which unfairly deprives a creditor of his just debt, without notice or compensation, the question becomes one of due process, which should have been raised and decided.[41] Perhaps a more satisfactory solution would be Congressional action requiring fair notice of the federal tax lien, or, as has been suggested,[42] a system of priorities similar to that in the Bankruptcy Act.

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[35] Compare *New Britain* with United States v. Gilbert Associates, Inc., 345 U. S. 361 (1953). The facts appear indistinguishable, although the cases were distinguished.
[36] Kennedy, note 4 *supra* at 929-30.
[37] 227 F.2d 359 (7th Cir. 1955), *rerv'd per curiam*, 350 U. S. 1010, *rehearing denied*, 351 U. S. 958 (1956).
[38] See Mr. Justice Douglas's dissent in United States v. White Bear Brewing Co., 350 U. S. 1010 (1956).
[39] United States v. White Bear Brewing Co., 227 F.2d 359 (7th Cir. 1955).
[40] Quoting Mr. Justice Story in United States v. State Bank, 31 U. S. (6 Pet.) 29, 35 (1832).
[41] Although due process was briefly mentioned in Chief Justice Moore's concurring opinion (307 P.2d at 479), a discussion of this point was conspicuously absent from the majority opinion.
[42] Kennedy, note 4 *supra* at 930.